NATIONAL OPEN UNIVERSITY OF NIGERIA
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FACULTY OF MANAGEMENT SCIENCES

ACC411 AUDITING II

Course Guide

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INTRODUCTION

You are holding in your hand the course guide for ACC411 (AUDITING II). The purpose of the course guide is to relate to you the basic structure of the course material you are expected to study as a student studying ACC411 in National Open University of Nigeria. Like the name 'course guide' implies, it is to guide you on what to expect from the course material at the end of studying the course material.

COURSE CONTENT

The course content consists basically of the required course outline students are expected to cover at this level.

COURSE AIM

The aim of the course is to equip you with the necessary information required in understanding auditing practice at this level.

COURSE OBJECTIVES

At the end of studying this course, among other objectives, you should be able to:

1. Explain the reasons for the regulation of audit and assurance services
2. Evaluate the need for harmonization of local and international auditing standards.
3. Discuss the actions an auditor should take in the event of non-compliance with laws and regulations by his client,
4. Understand the obligations of the auditor under the Money Laundering Act.
5. Appreciate the need for legislative regulation of accounting and auditing practices
6. enumerate the powers and functions of the Financial Reporting Council of Nigeria
7. explain the provisions of both the Sox Act 2002 and the FRC Act 2011 that are intended to enhance the independence of the auditor,
8. The role of the audit committee in ensuring good corporate governance and transparency in financial reporting.
9. Understand the two forms of audit testing
10. Explain the importance of sampling in audit testing
11. Discuss the importance of analytical procedures in the planning and conduct of audits
12. Conduct analytical procedures on a sample set of financial statements

COURSE MATERIAL

The course material package is composed of:

The Course Guide

The study units

Self-Assessment Exercises

Tutor-Marked Assignment

References/Further Reading

THE STUDY UNITS

The study units are as listed below:

Unit 1: Regulation of Audit and Assurance Services
Unit 2: Relevant Recent Legislations for the Regulation of Audit and Accounting Practices
Unit 3: Ethical Regulation: Rules of Professional Conduct
Unit 4: Auditor's Professional Liability
Unit 5: Audit Expectation Gap; Fraud and Error

Unit 6: Practice Management Part I (Quality Control: ISA 220 and ISQC 1)
Unit 7: Practice Management Part II
Unit 8: Audit Planning and Control
Unit 9: The Use of Computers in Auditing

Unit 10: Audit Testing, Sampling and Analytical Procedures

Unit 11: Audit Evidence and Using the Work of an Expert
Unit 12: Evaluation and Reviews

Unit 13: Reporting I (ISA 700 *Revised*)

Unit 14: Reporting II
Unit 16: Joint and Group Audits

Unit 17: Special Audits
Unit 18: Special Audits Part II - Public Sector Audit

Unit 19: Other Special Audits

Unit 20: Forensic Audits and Investigations/Due Diligence
Unit 21: Other Assignments

ASSIGNMENTS

Each unit of the course has self-assessment exercises. You will be expected to attempt them as this will enable you understand the content of the unit.

TUTOR-MARKED ASSIGNMENT

The Tutor Marked Assignments (TMAs) at the end of each unit are designed to test your understanding and application of the concepts learned. Besides, you would be assessed electronically, as a continuous assessment during the period of studying the course. This would make up 30 percent of the total score for the course. The other 70% would be determined by examination of the course at the end of the course.

SUMMARY

It is very important that you commit adequate effort to the study of the course material for maximum benefit. Good luck.

AUDITING II
ACC411
Main Content

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UNIT 1: REGULATION OF AUDIT AND ASSURANCE SERVICES

Content

1.0 Introduction

The accounting profession is one of the professions that largely enjoyed self-regulatory status world- wide; the profession hitherto had very minimal legislative regulation. But as a result of the dynamics and complexity of the business environment, and in particular high profile corporate failures associated with corporate governance and audit failures, there has been increasing legislative regulation of the accounting and auditing profession in recent decades.

This unit discusses the need for regulation, sources of regulation and some regulatory frameworks that govern auditing practices.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the reasons for the regulation of audit and assurance services
- Evaluate the need for harmonization of local and international auditing standards.
- Discuss the actions an auditor should take in the event of non-compliance with laws and regulations by his client,
- Understand the obligations of the auditor under the Money Laundering Act.

3.0 Main Content

3.1 Need for Regulation

Audit and Assurance services are regulated primarily for the **Public interest**. Investors take economic decisions on the basis of the credibility auditors lend to financial statements whenever they audit and certify the financial statements true and fair. Thus, it can be said that auditors give an impartial, professional view on issues that matter to users of financial and other information. It is important therefore that this view can be trusted. Auditors therefore need to operate within ethical boundaries and in compliance with standards, laws and regulations.

3.1.1 Sources of Regulation: Regulation of Audit and Assurance services is effected through:

- **Legal Regulation –** Most countries, including Nigeria, have legal requirements associated with some assurance providers, particularly auditors. Examples of these legal requirements are found in CAMA (Companies and Allied Matters Act), 2004, ICAN Act 1965, Banks and other Financial Institutions Act 1991, Insurance Act 2003, Securities and Exchange Commission (SEC) Act 2007, EFCC Act, the Audit Act, Financial Reporting Council of Nigeria (FRCN) Act 2011 etc.
- **Ethical Regulation –** Auditors are given ethical guidance by the professional Bodies e.g. ICAN, law and IFAC (International Federation of Accountants).
- **Professional Regulation –** Auditors are required to carry out audits according to professional standards (International Standards on Auditing –ISAs and Nigerian Standards on Auditing- NSAs). As assurance provision goes 'global' the harmonization of such professional guidance has become necessary.

3.2 Harmonisation of the accountancy and auditing profession

The International Federation of Accountants (IFAC) is an international regulatory body for the profession but each country has its own regulatory regime for auditing, which may not necessarily apply the same principles of audit behaviour as those used by IFAC. There has been increasing arguments in favour of the universal adoption of international auditing standards and other regulatory aspects of the auditing and accounting profession.

These include advantages that such adoption of global auditing standards would improve the efficiency of the audit process for multinational companies and should improve transparency in audit reporting.

Disadvantages include the problems of getting international agreement on auditing practices, and the need for many countries to change their local law to bring it in line with the agreed international practice.

A number of initiatives are taking place to harmonise the regulation of the auditing profession internationally. These include the following:

(i) Audits of all listed companies in the European Union should now be carried out in accordance with International Standards on Auditing.

(ii) Moves to establish a more formal, statute-based corporate governance regime (such as Sarbanes-Oxley in the USA).

(iii)The development of national regulatory models for the profession, headed by a single unified body. The Financial Reporting Council of Nigeria is envisaged to play this unifying role in Nigeria. Such a single unified body should set accounting and auditing standards, enforce and monitor compliance with those standards and oversee the self-regulatory professional bodies

3.2.1 Professional Standards

The international standard-setting process

International Standards on Auditing (ISAs) are set by the International Audit and Assurance Standards Board (IAASB), which is an arm of IFAC.

Whenever a need for standardization of an item is recognized, a subcommittee of IAASB writes an exposure draft (ED) of the new standard. This draft is then sent out to relevant partiesfor comments. These parties include individuals and organizations such as national standard setters (e.g. the Auditing Practices Board in the UK) and professional bodies, such as ICAN. The comments are reviewed within the IAASB and the draft is amended as required. Finally a new ISA will be issued.

Nigerian standards on auditing (NSAs)

The Financial reporting Council Act No. 6, 2011 established the Nigerian FRC (Financial Reporting Council) with the overall responsibility for setting auditing standards in Nigeria. The FRC works closely with institutions such as ICAN in developing local auditing standards. Nigerian Standards on Auditing (NSAs) are based on the ISAs issued by the IAASB. The ISAs are adapted to meet our local environment and peculiarities. However, the underlying substance of 'how to audit' and the approach to a risk-based audit remains the same in both ISAs and NSAs.

International standards are designed for use internationally and to promote consistency in audit and assurance practice. However, where there is a conflict between the ISAs and NSAs, the provisions of NSA will prevail. However, as ISAs represent international best practice, countries are encouraged by IFAC to change their national practice so that ISAs can be followed. Where there is no comparable guidance to the ISA in the country, then individual ISA practice can be adopted immediately.

3.2.2 Types of standards issued by IAASB and their Applications

The IAASB issues a number of other international standards, in addition to ISAs. The table below sets out these standards, including ISAs, and when they are to be applied.

Type of standard	When Applied
International Standards on Auditing (ISAs)	In the audit of historical financial information
International Standards on Review Engagements (ISREs)	In the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	In assurance engagements other than audits or reviews of historical financial information
International Standards on Related Services	On compilation engagements, engagements to

(ISRSs)	apply agreed upon procedures to information and other related services engagements
International Standards on Quality Control (ISQCs)	For all the above services

3.2.3 Consideration of Laws and Regulations in an Audit of Financial Statements (ISA 250)

The legal environment and non-compliance by a client company

ISA 250 Consideration of laws and regulations in an audit of financial statements requires the auditor to:

a) obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment as required by ISA 315
b) obtain sufficient appropriate audit evidence in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements
c) perform the following audit procedures to help identify such instances of non-compliance:
    - make enquiries of management as to whether or not the entity is complying with the relevant laws and regulations
    - inspect any correspondence with the relevant authorities
d) during the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliance to the auditor's attention
e) obtain written representations from management that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor
f) document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties.

Action by the auditor in the event of non-compliance or suspected noncompliance by a client company.

If the auditor identifies or suspects material areas of non-compliance by the company, the following procedures are required:

a) Obtain an understanding of the nature of the act and the circumstances under which it has occurred.
b) Evaluate the possible effect of the non-compliance on the financial statements.
c) For suspected non-compliance, discuss the matter with management. If compliance is not demonstrated, take legal advice.
d) If there is insufficient evidence of a suspected non-compliance, consider the impact on the audit report as this would constitute a "limitation on scope."
e) Consider whether or not the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment).
f) Consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities.

Self- Assessment Questions

1. Explain the reasons for the regulation of audit and assurance services.
2. Discuss the means through which audit and assurance services are regulated in Nigeria.
3. Explain why it is important that the auditor ensures that his clients comply with laws and regulations.

3.3 Money Laundering

3.3.1 Definition of money laundering

Money laundering can be defined as the process by which criminals attempt to conceal the true origin and ownership of the proceeds from their criminal activities, allowing them to maintain control over the proceeds and, ultimately providing a legitimate cover for the sources of their income (ACCA Code of Ethics and Conduct). Money laundering is a process by which money earned from criminal activities ('dirty money') is transferred and transformed so that it appears to have come from a legitimate source ('clean money'). Criminal activities include drug trafficking, terrorism, theft, tax evasion and other types of fraud.

By the provisions of Money Laundering (Prohibition) Act 2011, criminal offences connected with money laundering include:

- possessing, in any way dealing with, or concealing, the proceeds of any crime. Examples of the proceeds of crime might include the following:
    i. Tax evasion.
    ii. Offences that involve saved costs (as these could result from environmental offences or failure to follow health and safety regulations).
    iii. Retaining overpayments from customers.
    iv. Payments made overseas that are deemed to be bribes and would be illegal in Nigeria.
- attempting, conspiracy or incitement to commit the above offence
- aiding, abetting, counseling or procuring the commission of such an offence
- an act which would constitute any of these offences if done in Nigeria
- failure by a person in the regulated sector to inform the appropriate party of a knowledge or suspicion that another person is engaged in money laundering
- failure to make a disclosure which is likely to prejudice an investigation into money laundering (tipping off).

Accountants may be inadvertently affected by the last two offences as they operate in the regulated sector and are therefore required to report suspicions of money laundering.

In expanding the scope of Money laundering offences, section 15 (2) and (6) of The Money Laundering (Prohibition) (Amendment) Act 2012 state:

(2) Any person or body corporate, in or outside Nigeria, who directly or indirectly:

(a) conceals or disguises the origin of; (b) converts or transfers; (c) removes from the jurisdiction; or (d) acquires, uses, retains or takes possession or control of any fund or property, knowingly or reasonably ought to have known that such fund or property is, or forms part of the proceeds of an unlawful act, commits an offence of money laundering under this Act.

(6) The unlawful act referred to in subsection (2) of this section includes participation in an organized criminal group, racketeering, terrorism, terrorist financing, trafficking in persons, smuggling of migrants, sexual exploitation, sexual exploitation of children, illicit trafficking in narcotic drugs and psychotropic substances, illicit arms trafficking, illicit trafficking in stolen goods, corruption, bribery, fraud, currency counterfeiting, counterfeiting and piracy of products, environmental crimes, murder, grievous bodily injury, kidnapping, hostage taking, robbery or theft, smuggling (including in relation to customs and excise duties and taxes), tax crimes (related to direct taxes and indirect taxes), extortion, forgery, piracy, insider trading and market manipulation or any other criminal act specified in this Act or any other law in Nigeria.

3.3.2 Stages in Money Laundering

There are three stages in Money laundering:

1. *Placement*: Placement involves physically introducing or placing illegally obtained money into the financial system or the retail economy. Examples include making lots of small cash deposits in numerous bank accounts; using a cash intensive business such as a used car dealership to disguise 'dirty' money as legitimate revenue etc.
2. *Layering*: Layering is the separation of illegally obtained money from its source through a series of financial transactions that makes it difficult to trace the origin. At this stage, 'dirty' money is passed through a large number of transactions or 'layers', so that it becomes difficult to trace it to its original source.
   During the layering phase of money laundering, criminals often take advantage of legitimate financial mechanisms in attempts to hide the source of their funds. Examples include:
   - Transferring the money through multiple bank accounts, across different national jurisdictions;
   - Making numerous purchases and sales of investments;
   - Making fake sales between controlled companies, e.g. through over-invoiced transactions that do involve a transfer of goods.
3. *Integration:* Integration means converting the illicit funds into a seemingly legitimate form. The criminal now has 'clean' money which can be spent in a legitimate economy. Integration may include the purchase of businesses, automobiles, real estate and other assets.

3.3.3 Regulation

Due to the work of inter-governmental bodies such as the Financial Action Task Force (FATF), on Money Laundering many countries now have legal provisions in place designed to detect, report and ultimately prevent money-laundering activities. In Nigeria the Money Laundering (Prohibition) Act, 2011 as amended, implements the recommendations of FATF in relation to customer due diligence, record-keeping, reporting of suspicious transactions and compliance.

Professional Accountants/Accounting Firms become Vulnerable when:

a. There is less scrutiny: This attracts criminals as they may not be subjected to stringent Anti-money Laundering (AML) requirements.

b. They protection of clients – Promotes secrecy and anonymity which attracts criminals

c. There is lack of awareness/ignorance of the laws – creates a weak link in combating money laundering

d. there is lack of or inadequate AML program – No training on AML, inadequate internal control measures etc

e. there is collusion by unscrupulous Accounting professionals

3.3.4 Obligations placed on professional firms

Criminals establish companies and use transactions between their companies to 'launder' their dirty money. This places an obligation on auditors to detect and report money laundering activities. Specific obligations for detecting and reporting suspicions of money laundering are placed on professional firms (for example, lawyers and accountants) and financial institutions. These requirements include the following:

a. Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
b. Appointing a Money Laundering Reporting Officer (MLRO), whose responsibility is to receive reports on suspected money laundering activities from other employees and report them to the appropriate authorities.
c. Establishing and enhancing the record-keeping systems (1) for all transactions (which must be kept for at least **five** years, with controls to ensure that they are not inadvertently destroyed) and (2) for verifying the identity of clients (by obtaining official documents, such as – for an individual – passport or driving license, supported by recent utilities bills, and – for a company – certificate of incorporation).
d. Establishing procedures within the firm for reporting any suspicion of money laundering by client companies.
e. Training and educating staff in procedures for detecting and reporting suspicions of money laundering activities.

3.3.5 Guidance from professional bodies

To ensure that practitioners are aware of their responsibilities, ICAN's Monitoring Unit – as part of its monitoring process –enquires into the level of accounting firms' understanding of theirobligations under the money laundering Act during their visits. In addition to any disciplinary action that may be taken by ICAN for breaches of the regulations, penalties for non-compliance with money laundering obligations can:

i. make a firm liable (under criminal law) to unlimited fines, and
ii. make its principals (usually its partners) liable to possible imprisonment.

3.3.6 Duty of confidentiality and money laundering

The accountant's normal professional duty of confidentiality to clients is not an adequate defence where money laundering is concerned. In the case of reporting suspicions of money laundering, practitioners in most countries are afforded statutory protection against claims for breach of confidence where reports are made in good faith and to the appropriate authority. This will be so even in cases where the suspicions later prove to be unfounded and wrong.

3.3.7 Steps involved in assessing the risks associated with money laundering:

- Identifying the money laundering risks that are relevant to the business.
- Carrying out a detailed risk assessment on such areas as customer behaviour and delivery channels.
- Designing and implementing controls to manage and reduce any identified risks.
- Monitoring the effectiveness of these controls and make improvements where necessary.
- Maintaining records of actions taken and reasons for these actions.

3.3.8 Steps involved in curbing money laundering:

- Legislation – Different laws by government to discourage and checkmate perpetrators and potential perpetrators.
- Information and education – Enlightenment campaigns on dangers of money laundering.
- Identifying the likely businesses such as new customers carrying out large one-off transactions
- Probing suspicious deals and lodgments
- Prosecution
- On-going monitoring of businesses
- Introduction of Bank Verification Number

4.0 Conclusion

Auditing practice is regulated for the interest of the investing public. Sources of regulation include legislation, professional and ethical guidance. As a result of the increasing complexity of the business environment, the extent of regulation of the auditing and accounting practices has increased in recent times.

5.0 Summary

In this unit, we discussed the need for regulation of auditing practice and the sources of relation. We also examined guidance given by ISA 250 on compliance with laws and regulations and the auditor's duty in this respect. Finally, the provisions of the Money Laundering Act 2011 as amended were discussed as well as the obligations of the auditor under this Act.

6.0 Tutor-marked Assignment

1. Discuss the advantages and disadvantages of harmonisation of auditing practices.

2. Explain the actions an auditor should take if his client fails to comply with the requirements of ISA 250 *Compliance with laws and regulations.*

3. Money laundering has become a global concern due to its impact on the global economy. IMF has stated that about 2 – 5% of world GDP is likely to be related to money laundering.

Required:

a. Explain the term ‘money laundering’ and describe the stages involved in money laundering. (5 marks)
b. Discuss the role and obligation of professional accounting firms in detecting and reporting money laundering activities. (10 marks)
c. Describe the steps involved in assessing the risks associated with Money laundering (5 marks)

(Total: 20 marks)

7.0 References/Further Reading

1. ICAN (2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International

2. Money Laundering (Prohibition) Act 2011 as amended

3. International Standards on Auditing (15A) 250.

UNIT 2: RELEVANT RECENT LEGISLATIONS FOR THE REGUATION OF AUDIT AND ACCOUNTING PRACTICES

Content

1.0 Introduction

The need to curb corruption, irregularities and fraud, and streamline the oversight of accounting and corporate governance practices following spates of accounting and Corporate Governance failures, has led to the enactment of some local and international legislations that have effects on accounting and audit. Legislations of interest in this area include The Financial Reporting council of Nigeria Act, No.6, 2011, the Public Accounting and Investor Protection (Sarbanes-Oxley) Act 2002 (USA), the Code of corporate governance, the Corrupt Practices and Other Related Offences (Anti-Corruption) Act, 2002, and the Economic and Financial Crimes Commission (EFCC) Act 2004. This unit examines the *first three legislations* and their influence on the audit of financial statements.

2.0 Objectives

By the end of this unit, you will be able to:

- Appreciate the need for legislative regulation of accounting and auditing practices
- enumerate the powers and functions of the Financial Reporting Council of Nigeria
- explain the provisions of both the Sox Act 2002 and the FRC Act 2011 that are intended to enhance the independence of the auditor,
- The role of the audit committee in ensuring good corporate governance and transparency in financial reporting.

3.0 Main Content

3.1 Financial Reporting Council Act.

This Act was enacted to take over the Standard setting and oversight functions of the Nigerian Accounting Standards Board (NASB) but with enhanced functions. The council has 7 Directorates with functions, some of which impact directly accounting and auditing practices. The Directorates are :

a). Directorate of Accounting Standards – Private Sector: with the responsibility of developing accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and SMEs.

b). Directorate of Accounting Standards – Public Sector: develops accounting and financial reporting standards for the public sector.

c). Directorate of Auditing practices Standards: develops or liaise with relevant professional bodies on auditing and ethical standards set by it.

d). Directorate of Actuarial Standards: develops an appropriate conceptual framework to guide the setting of relevant actuarial standards.

e). Directorate of Inspection and Monitoring: Monitors compliance with auditing, accounting, actuarial and valuation standards and guidelines reviewed and adopted by the council as well as recommend sanctions to council and implement sanctions and fines approved by council.

f). Directorate of Valuation Standards: develops an appropriate conceptual framework to guide the setting of relevant actuarial standards.

g). Directorate of Corporate Governance: Develops principles and practices of Corporate Governance as well as promote the highest standards of corporate Governance.

See ss.24 -29, 50 for detailed and specific functions of these directorates.

Power of the Council

Section 7(2) of the Act outlines the power of the council (as it relates to audit and Accounting) to include:

a). enforcing and approving enforcement of compliance with accounting, auditing, corporate governance and financial reporting standards in Nigeria;

b). co-operating with or becoming a member or affiliate of any similar international body the objects or functions of which are similar to or connected with those of the council;

c). requiring management assessment of internal controls, including information systems controls with independent attestation;

d). requiring code of ethics for financial officers and certification of financial statements by the CEO and CFO.

e). requiring entities to provide real time disclosures on material changes in financial conditions or operations; and

f). pronouncing forfeiture, by CEO and CFO, of certain bonuses received from the company and profits realized from the sale of company shares owned by them, where the company is required to prepare an accounting restatement.

Functions of the Board (section 8)

The Council shall –

a). develop and publish accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities;

b). review, promote and enforce compliance with the accounting and financial reporting standards adopted by the Council;

c). receive notices of non-compliance with approved standards from preparers, users, other third parties or auditors of financial statements;

d). receive copies of annual reports and financial statements of public interest entities from preparers within 60 days of the approval of the Board;

e). advise the Federal Govt. on matters relating to accounting and financial reporting standards;

f). maintain a register of professional accountants and other professional professionals engaged in the financial reporting process;

g). monitor compliance with the reporting requirements specified in the adopted code of corporate governance;

h). promote compliance with the adopted standards issued by the International Federation of Accountants and International Accounting Standards Board;

i). monitor and promote education, research and training in the fields of accounting, auditing, financial reporting and corporate governance;

j). conduct practice reviews of registered professionals;

k). review financial statements and reports of public interest entities;

l). enforce compliance with the Act and the rules of the Council on registered professionals and the affected public interest entities.

m). establish such systems, schemes or engage in any relevant activity, either alone or in conjunction with any other organization or agency, whether local or international, for the discharge of its functions.

n). receive copies of all qualified reports together with detailed explanations for such qualifications from auditors of the financial statements within a period of 30 days from the date of such qualifications from auditors of the financial statements within a period of 30 days from the date of such qualification and such reports shall not be announced to the public until all accounting issues relating to the reports are resolved by the Council;

o). adopt and keep up-to-date accounting and financial reporting standards and ensure consistency between standards issued and the International Financial Reporting Standards;

p). specify in the accounting and financial reporting standards the minimum requirements for recognition, measurement, presentation and disclosure in annual financial statements, group annual financial statements or other financial reports which every public interest entity shall comply with, in the preparation of financial statements and reports;

q). develop or adopt and keep up-to-date auditing standards issued by relevant professional bodies and ensure consistency between the standards issued and the auditing standards and pronouncements of the International Auditing Assurance Standards board; and

r). perform such other functions which in the opinion of the Board are necessary or expedient to ensure the efficient performance of the functions of the council.

Objects of the council (section 11)

1. To protect investors and other stakeholders interest
2. To give guidance on issues relating to financial reporting and corporate governance
3. To ensure good corporate governance practices in the public and private sectors of the Nigerian economy
4. To ensure accuracy and reliability of financial reports and corporate disclosures , pursuant to various laws and regulations currently in existence.
5. Harmonize activities of relevant professional and regulatory bodies as relating to Corporate Governance and Financial Reporting.

Registration of Professionals

The Act empowers the council to register qualified professionals before they can offer services for remuneration to public interest entities. The registration is renewable every 2 years (s.42). The council shall maintain a register of professionals (s.41) and is empowered to de-register any professional where the professional:

1. has obtained the registration by fraud or misrepresentation
2. no longer satisfies the requirements for registration.
3. Has acted in breach of any rule or regulation made by the council.

Auditor’s Report and Opinion

Section 44 of the Act requires the professional Accountant to express a clear written opinion in is report, giving details as to whether –

a. The financial statements as a whole give a true and fair view of the state of affairs of the entity to which they relate;
b. The financial statements comply with the provisions of the FRCN Act, or any other relevant enactments

The Accountant is precluded from expressing an opinion unless he has complied with the auditing standards and where the directors disclose the extent of compliance with the Code of Corporate Governance in the entity's annual report, the Accountant shall report separately whether the disclosure is consistent with the requirements of the code.

Material Irregularity

Section 45 of the Act stipulates:

1. Where during the course of the audit of an entity, a professional Accountant is satisfied or has reason to believe that a material irregularity has taken or is taking place, he shall without delay –
   (a) Notify in writing the CEO of the public entity and all members of the Board of the entity of the irregularity, giving particulars of the irregularity; and
   (b) Request every person referred to in (a) above, either individually or collectively to take such action as the professional accountant may deem necessary.
2. The professional accountant shall within 30 days of the issuance of the notice in sub-section 1, notify the Council of the material irregularity, together with any other relevant information.

Auditor's Independence

The Auditor in the performance of his audit function exercise absolute independence and shall not:

a. Act in any manner contrary to the Code of Conduct and Ethics that may be made by the council or under any enactment in force; or
b. Engage in any activity which is likely to impair his independence as a professional (s.46)

Conflict of interest

The nature of any conflict of interest in relation to an engagement is required to be disclosed to the entity and council (FRCN) in order to enable the entity determine the extent of the conflict and to decide whether or not to continue retaining the services of the professional Accountant (s.47).

Practice Review of Professional Accountants (s.60)

The Council or any officer authorized in writing may review the practice of an auditor and may for that purpose:

a. Inspect any relevant books, documents and records in the possession or under the control of the auditor, his partner or employee, and make copies of or take any abstract of or extract from any such book, document and record in relation to a company under investigation subject to the consent of the public interest entity; and
b. Seek information or clarification from any partner or employee of the professional.

Self-Assessment questions

1. Discuss the oversight functions of the Financial Reporting Council of Nigeria in the following areas:

a. Practice Review and Quality Assurance
b. Corporate Governance Matters.

2. What are the powers of financial reporting council of Nigeria?

3.2 The Sarbanes-Oxley (SOx) Act 2002

The Public Accounting Reform and Investor Protection Act (called Sarbanes-Oxley Act – after the names of the two principal Congress men that sponsored the bill), was passed into law on July 30, 2002, following series of Accounting and Corporate Governance failures, especially those of Enron and worldcom – both audited by Arthur Andersen. The target was to regulate the companies registered under SEC in US but today the Act has gained World -wide recognition and acceptance.

The Public Corporations Accounting Oversight Board (PCAOB) was established to ensure compliance with the provisions of the Act. The major provisions of the Act relating to audit and accounting are:

1. The establishment of a proper internal control system
2. Management assuming responsibility for the truth and fairness of the financial statements
3. At least one member of the audit committee must be a financial expert. A financial expert as defined by the Act, is a person who through education or experience has –
    - understanding of financial statements and GAAP
    - Experience in applying GAAP in connection with accounting as relates to the financial statements of the enterprise;
    - Experience in preparing or auditing financial statements that present accounting issues
    - Experience with internal control procedures for financial reporting; and
    - An understanding of audit committee functions.
4. Preserving audit working papers for at least seven years.

The Act also has a provision for the establishment by corporations, of "whistle blower" programmes for anonymous reporting of fraudulent accounting and audit practices. The Act ensures protection for whistle blowers – Sect.806.

3.2.1 Oversight and Regulatory Functions of PCAOB

These include:

a. Registration of public accounting firms that audit public companies. Registration requirements include disclosure of fees collected from the audit, audit programmes and quality standards, details of engagement team members for the particular audit, and any pending criminal, civil or administrative litigations.
b. Establishing auditing standards, requiring mandatory compliance.
c. Conducting quality inspection of registered firms
d. Conducting investigations and sanctioning unethical behaviors
e. Performing other standard and quality related functions as the board may decide from time to time.
f. Enforcing compliance with Sox provisions.

3.2.2 Specific Rules Applicable to the audit of Companies

Some of the PCAOB specific rules applicable to the audit of public interest entities/corporations include –

1. Retention of audit Papers: A minimum period of 7 years is prescribed for the retention of audit working papers.
2. Concurring Partner's approval: requires a second partner, internal or external to approve the audit report before it is issued. The concurring partner will need to co-sign the report.
3. Scope of internal control system: Scope is increased as the auditor is required to report on his findings after a complete review of the internal control.
4. Evaluation of the internal control structure and procedure: The board has established models for the evaluation of the internal control system by the external auditor which requires the auditor to report on his findings relating to identified weaknesses and all cases of material non-compliance.
5. Audit quality control standards: will need to comply with ISO 9000 quality standards. Thus, Sox requires that public accounting firms set standards relating to:
    i. Monitoring of professional ethics and independence;
    ii. Procedures for resolving auditing and accounting disputes within the firm
    iii. Supervision of audit work
    iv. Hiring, professional development and advancement of personnel;
    v. Standards for the acceptance and continuation of engagements;
    vi. Internal control inspections; and

vii. Other quality standards prescribed by PCAOB.

3.2.3 Independence of Public Auditors

One of the major issues in the Enron-Andersen saga was that Arthur Andersen performed both external and internal audit functions for Enron Corporation. Sox makes it illegal for an auditor to provide services in both capacities. Other prohibited services by public Accounting firms to the same company where they are engaged as external auditors include:

1. Financial information systems design and implementation, as they are required to evaluate and report on the accounting and financial information systems of the company.
2. Book keeping and accounting services.
3. Management and human resources functions – senior audit personnel of the accounting firm are not allowed to be employed in senior accounting positions of the companies the firm serves as external auditors.
4. Other prohibited services include actuarial services, investment advisor, and accounting related legal services

3.2.4 Other Provisions with indirect impact on the work of the Auditor

1. The consent of the audit committee is required before any approval of all audit and non-audit services.
2. The lead audit partner for an engagement to be mandatorily rotated at least every 5 years.
3. External auditors are to report to the audit committee – Under Sox, the auditor is to report to the audit committee all alternative accounting treatments adopted by management and the auditor's preferred treatment.
4. To enhance the independence of the audit committee, only non-executive directors may be appointed members. The non-executive members of the committee must not accept any consulting or advisory fees from the corporation and from any affiliated subsidiary of associated company.
5. At least, one member of the audit committee should be a financial expert.

3.2.5 Corporate Responsibility for Financial Reports

Under Sox, the directors and principal officers (CEO and CFO) are required to certify the reports and accounts filed and accept responsibility for their truth and fairness. Similar provision/requirement has been adopted in Nigeria. See statement of Directors' responsibility and Certification Pursuant to S.60 (2) of ISA 2007 given in earlier lesson.

In addition, the Act makes it unlawful for any officer, director to take any actions calculated to fraudulently influence, coerce, manipulate or in any way mislead the auditor for the purpose of rendering the financial statements materially misleading.

3.2.6 Forfeiture and Penalties aimed at Promoting Good Corporate Governance

1. If an enterprise is required by SEC to restate its earnings owing to material violation of the Securities Act, the CEO and CFO will reimburse any bonuses or incentives received on the basis of the original earnings.
2. If someone by his conduct demonstrates any unfitness to serve as director, the court is empowered to bar such person acting as director or officer of a corporation.
3. If there are indications of distress in a corporation, Sox prescribes a period of fund black out for officers and directors of the corporation. This is to prevent them(for they have insider knowledge) from disposing their shares in the corporation prior to the final collapse of the entity.
4. Legal advisers who have knowledge of material violations of the Securities law, are required to report such violations to the CEO for corrective actions, failing which he should take the matter to the audit committee.
5. Provision for "disgorgement" fund for investors who have suffered loss. That is, where an investor has suffered loss as a result of fraud or improper accounting, and recoveries are made from the perpetrators, such recoveries are required to be paid as financial settlement to the parties who suffered loss.

Self-assessment question

1. Discuss the provisions of the Sox Act 2002 that aim to enhance the independence of the auditor.

4.0 Conclusion

Increasing corporate and audit failures have led to increasing legislative regulation of audit practice across different jurisdictions. In Nigeria, The Financial Reporting Council Act 2011 is promulgated to address this problem and thus has become a major regulatory framework for auditing and accounting in Nigeria. In the United States, the Sox Act 2002 was an immediate response to the failures of Enron and Worldcom and this piece of legislation has gained worldwide acceptance and adaptation as at date. As a further response to these failures, increasing attention is being paid to corporate governance practices worldwide including Nigeria.

5.0 Summary

This unit surveyed the provisions of the FRC Act 2011, the Sox Act 2002 and the Corporate governance codes in Nigeria and their impact on accounting and auditing practices in Nigeria. The roles of the key players in Corporate governance, namely, Audit Committee, Board of directors, Accountants and auditors as well as shareholders, in ensuring transparency in financial reporting were highlighted.

6.0 Tutor-marked assignment

1. Spates of Audit and Corporate Governance failures in recent decades, have led to the enactment of some local and international legislations that have effects on accounting and audit. Some of these legislations include The Financial Reporting council of Nigeria (FRCN) Act,

No.6, 2011 and the Public Accounting Reform and Investor Protection (Sarbanes-Oxley) Act 2002.

Required:

a. Outline the objects of the Financial Reporting Council of Nigeria. (5 marks)

b. With reference to section 45 of the FRC Act, state the communication responsibility of the auditor if, in the course of his audit of an entity, he has reason to believe that a material irregularity has taken or is taking place. (3 marks)

c. The Public Accounting Oversight Board (PCAOB) established under the Sarbanes-Oxley Act has given some specific rules applicable to the audit of public companies. Describe **five** of these specific rules. (5 marks)

d. To enhance the independence of the auditor, the Sox Act makes it illegal for an Accountant to render certain other services to the client while still in office as an auditor of the company. State any **two** of such prohibited services. (2 marks)

(Total: 15 marks)

7.0 References/further reading

1. Financial Reporting Council of Nigeria Act No. 6, 2011.
2. Public Accounting Reform and Investor Protection Act (called Sarbanes-Oxley Act) 2002.
3. Hayes, R et al(2005), Principles of Auditing: An introduction to international standards on auditing. England: Prentice Hall (Pearson Education Publishers).
4. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.
5. FGN, Companies and Allied Matters Act, cap C20 LFN 2004

UNIT 3: ETHICAL REGULATION: RULES OF PROFESSIONAL CONDUCT

Content

1.0 Introduction

As we noted in unit 1, ethical regulation of audit and assurance services comes largely from the professional bodies. This unit extendsour study in Audit and Assurance 1 on the fundamental ethical principles given by the IFAC Code of Ethics, with emphasis on possible threats to the auditor's independence and objectivity as well as some safeguards that could be applied to mitigate the effect of such threats.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the fundamental ethical principles as stipulated by the IFAC Code of ethics/ICAN Rules of Professional Conduct and Guide for members.
- Evaluate why it is necessary for members of the profession to observe these principles in their conduct and practice
- Discuss the ethical threats to objectivity and independence of the auditor and proffer possible safeguards to such threats
- Given real life scenarios, identify and explain how to deal with possible threats to independence and objectivity.

3.0 Main Content

3.1 Fundamental Ethical Principles

Both the IFAC and ICAN codes give the following fundamental ethical principles namely:

(a) *Integrity:* The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

(i) Contains a materially false or misleading statement;

(ii) Contains statements or information furnished recklessly; or

(iii Omits or obscures information required to be included where such omission or obscurity would be misleading.

Where such issues as above have arisen, a professional accountant shall take steps to be disassociated from that information and is advised to issue a modified report..

(b) *Objectivity* –A professional Accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments. A professional accountant may be exposed to situations that may impair objectivity. A professional accountant shall not perform a professional service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that service.

(c) *Professional Competence and Due Care* – The Accountant has the obligation to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards. Members shall act diligently and in accordance with applicable technical and professional standards.

Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a professional accountant to develop and maintain the capabilities to perform competently within the professional environment.

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

(d) Confidentiality – The Accountant has the obligation to respect the confidentiality of information acquired as a result of professional and business relationships. He should therefore, not disclose any such information to third parties without proper and specific authority, unless

there is a legal or professional right or duty to disclose. He must not use such information for his personal advantage or that of third parties.

The need to comply with the principle of confidentiality continues even after the end of relationships between a professional accountant and a client or employer. However, when a professional accountant changes employment or acquires a new client, the professional accountant is entitled to use prior experience.

A professional accountant shall maintain confidentiality, including in a social environment, being alert to the possibility of inadvertent disclosure, particularly to a close business associate or a close or immediate family member.

A professional accountant shall maintain confidentiality of information within his firm or employing organization including information disclosed by a prospective client or employer.

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Circumstances where professional accountants may disclose Confidential Information

The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

(a) Disclosure is permitted by law and is *authorized by the client* or the employer;

(b) Disclosure is *required by law*, for example:

(i) Production of documents or other provision of evidence in the course of legal proceedings; or

(ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is *a professional duty or right to disclose,* when not prohibited by law:

(i) To comply with the quality review of a member body or professional body;

(ii) To respond to an inquiry or investigation by a member body or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical standards and ethics requirements.

In deciding whether to disclose confidential information, relevant factors to consider include:

(a) Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant;

(b) Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any;

(c) The type of communication that is expected and to whom it is addressed; and

(d) Whether the parties to whom the communication is addressed are appropriate recipients.

(e) Professional Behavior - The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that

time, would likely to conclude that it would adversely affect the good reputation of the profession.

In marketing and promoting themselves and their work, professional accountants shall not bring the profession into disrepute. Professional accountants shall be honest and truthful and not:

(a) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

(b) Make disparaging references or unsubstantiated comparisons to the work of others.

Self-assessment questions

Explain the fundamental ethical principles contained in IFAC's Code of ethics.

3.1.1 Auditor Independence and Objectivity

Independence of the auditor adds credibility to the audit report on which users of the financial information depend to make economic decisions about a company. Thus, auditor independence is one of the basic requirements to keep public confidence in the reliability of the audit report. The benefits of safeguarding the independence of the auditor therefore extend so far as to the overall efficiency of the capital market.

Independence is described by the IFAC Code as:

- Having a position to take an unbiased view point in the performance of audit tests, analysis of results and attestation in the audit report;
- Independent in fact: accountant's ability to maintain an unbiased attitude throughout the audit, so being objective and impartial;
- Independent in appearance: the result of others' interpretations of this independence.

In this regard, the IFAC ethics guideline states that independence requires:

i. **Independence of mind**: The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

ii. **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 a firm's or a member of the assurance team's integrity, objectivity and professional skepticism had been compromised.

3.1.2 Potential Threats to Independence and Objectivity and Safeguards

Threats to independence and objectivity may arise in the form of self-interest, self-review, advocacy, familiarity and intimidation threats. Appropriate safeguards need to be put in place to eliminate or reduce such threats.

(a) **Self-interest threat**

This is the threat that “a financial or other interest of the professional accountant or of immediate or close family member will inappropriately influence the professional accountant’s judgment, conduct or behaviour. Thus, self-interest threat may arise from:

i. *Financial Interest*: May exist where an audit firm, for example, owns shares in the client company or is a trustee of a trust that holds shares in the client. In this regard the following are not allowed to own direct financial interest or an indirect material financial interest in a client –

- The audit firm;
- A member of the audit team;
- An immediate family member of an engagement team member.

Relevant safeguards:

- Disposing of the interest
- Removing the individual from the team if required
- Keeping the client’s audit committee informed; and
- Using an independent partner to review work carried out, if necessary.

ii. Close business relationships: These arise from commercial relationships or common financial interests between the audit client (or its management) and the audit firm, audit team member or a member of the team member’s family. Examples include joint venture arrangements, distributing or marketing arrangements etc.

The materiality and significance of such interests will need to be evaluated by the partners. If found significant, the audit provider should not participate in such venture with an audit client.

Appropriate safeguards are to terminate the business relation or disengage from the audit assignment. If an engagement team member is involved, he should be removed from the team.

iii. *Employment with an audit client*: The severity of the threat will depend on the cadre of the audit staff that transferred to the audit client. An audit staff employed by the client might want to impress the employer (self-interest threat); a former audit partner turned Finance Director has too much knowledge of the audit firm’s systems and procedures. In general, there may be familiarity and intimidation threats when a member of the audit team joins an audit client.

iv. *Gifts and hospitality*: Unless the value of the gift is inconsequential, it should not be accepted. For example, a two- month paid holiday abroad or a car gift is likely to constitute a threat to independence.

v. *Loans and Guarantees*: Where the loans from a bank or other lending institution, either to the firm or individual team members are material, they constitute a threat, unless they are on normal commercial terms. Otherwise, an independent review of the work done for such client, by a partner other than the engagement partner will be needed for a safeguard.

Note: An audit firm or engagement team member should not enter into a loan or guarantee arrangement with a client that is not a bank or similar institution. There would be no appropriate safeguard for the self-interest threat created.

vi. *Overdue Fees*: If audit fees due from a client remain unpaid for a long time, especially if not paid before the issue of the audit report for the following year, a self-interest threat arises. If the fee becomes long overdue, the auditor runs the risk of, in effect, making a loan to the client against ethical guidance.

vii. *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. Firms are not allowed to enter into such arrangements as they constitute a self-interest threat.

Unless suitable safeguards are in place, it is also inappropriate to accept a contingent fee for non-assurance work. Suitable safeguards will include:

- Using professionals who are not part of the audit team for the non-assurance work;
- Having the relevant audit work reviewed by an independent professional accountant.

viii. *High percentage of fees:* When a firm receives a high proportion of its fee income from one client, there arises a self –interest threat and/or intimidation threat, as the firm will be concerned about losing the client. The severity of threat depends on whether the firm is established or new; the operating structure of the firm and the significance of the client to the firm.

Possible safeguards include:

- Reducing the dependency on the client;
- External quality control reviews; or
- Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit adjustments.

viii. *Lowballing:* This is a practice of charging less than the market rate for an audit when tendering for new clients. When a firm quotes a significantly lower fee level for an audit service than would have been charged by the predecessor firm, there is a significant self-interest threat.

Suitable safeguards, if the tender is successful include:

- Complying with all applicable auditing standards, guidelines and quality control procedures
- Maintaining records that can help demonstrate that appropriate staff and time are allocated to the engagement.

(b) **Self-review threat**

There is a self-review threat when a professional accountant reviews his or her own work or advice as part of an assurance engagement. He/she will not appropriately evaluate the results of a previous judgment made or service performed by him/her on which the accountant will rely when forming a judgment as part of providing a current service.

Examples of circumstances which create self-review threat for a professional accountant in public practice include:

i) *Recent service with an audit client*: Individuals who have served as director or officer of the audit client or an employee in a position to exert significant influence over the preparation of the accounting records or financial statements in the period covered by the audit report should not be assigned to the audit team.

Where the individual had been so closely involved, the audit firm should consider the threat to independence arising and apply appropriate safeguards such as:

- Obtaining quality control review of the individual's work on the assignment.
- Discussing the issue with the audit committee.

ii) *Preparing accounting records and financial statements*: Preparing accounting records and financial statements and then auditing them pose a significant self-review threat. However, in practice auditors routinely assist management in preparing financial statements and give advice about accounting treatments.

Appropriate safeguards to reduce the risk arising to an acceptable level include:

- Using staff members other than the engagement team members to do the accounting work
- Obtaining client approval for work done.

Where the audit client is a public interest entity, the rules are more stringent. A firm must not provide accounting, book keeping and payroll services or prepare financial statements on which the firm will express an opinion, for a client.

iii) *Valuation Services*: An accountant may be asked by a client to carry out a specialist valuation. Specialist valuations include:

- actuarial valuations
- valuations of intellectual property and brands
- valuations of other intangible assets
- valuations of property
- valuations of unquoted investments.

Specialist valuations do not include valuations of shares prior to a stock exchange listing.

A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques and the combination of both in order to compute a certain value or range of values for an asset, a liability or for a business as a whole.

A firm is not permitted to carry out valuations on matters that would have material effect, separately or in aggregate, on the financial statements on which the firm will express an opinion.

For non-public interest entities, a firm should not carry out valuation on matters which will be material on the financial statements, which will involve a significant degree of subjectivity.

If the valuation is for immaterial matter, appropriate safe guards should be applied to reduce the risk to an acceptable level. Safeguards include:

- Second partner review
- Confirming that the client understands the valuation and the assumptions used
- Ensuring that the client accepts responsibility for the valuation
- Using separate personnel for the audit and the valuation.

iv) *Taxation services*: This falls into 4 categories –

i. Tax return preparation: Does not generally threaten independence, as well as management takes responsibility for the returns.

ii. Tax calculations for the purpose of preparing accounting entries: May not be permitted for public interest entities, except in emergency situations. For non-public interest entities, it is acceptable to do so provided safeguards are in place
iii. Tax planning may be acceptable in certain circumstances e.g. where the advice is supported by tax authority and other precedent.
iv. Assistance in resolution of tax disputes: May be provided in certain circumstances provided the service which is the subject of dispute was not provided by the auditor.

v) *Internal audit services*: A firm may provide certain internal audit services to an audit client provided the audit firm's personnel do not assume management responsibilities. To avoid inadvertently assuming management responsibility, the firm should ensure that senior management of the client accepts responsibility for designing, implementing and maintaining internal control and continue to approve the scope, risk and frequency of internal audit services.

vi) *IT System Services:* Significant threat will arise if an audit firm provides services to an audit client involving the design or implementation of IT systems that:

- Form a significant part of the internal control over financial reporting or
- generate information that is significant to the client's accounting records or financial statements.

The implementation of 'off-the-shelf' accounting or financial reporting software and making recommendations in relation to a system not designed, implemented or operated by the audit firm is permitted.

c) **Advocacy threat**

This threat arises in those situations where the professional accountant will promote the position of a client or employer to the stage that the professional accountant's objectivity is compromised. Examples of circumstances which create advocacy threats for a professional accountant who is in public practice include:

(i) When the firm is promoting shares in an audit client (selling, underwriting or otherwise dealing in financial securities or shares of the client); and

(ii) When a professional accountant is acting as an advocate on behalf of an audit client in litigation or resolving disputes with third parties when the amounts involved are material to the financial statements on which the firm will express opinion.

Safeguards will include:

- using different departments to carry out the work
- making disclosures to the audit committee.

d) Familiarity threat: This is the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Examples of circumstances which may create familiarity threats include:

i) a member of the assurance team having a close or immediate family member who is a director or officer of the assurance client;
ii) a member of the assurance team having a close or immediate family member who is an employee of the client and in a position to significantly influence the subject matter of the assurance engagement;
iii) A former partner of the firm being a director, officer of the assurance client or an employee in a position of significant influence;
iv) Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the client, its directors or employees; and
v) long association of a senior member of the assurance team with the assurance client.
Possible safeguards include:

- Rotating the senior personnel off the audit team
- Review of the work by an independent person (not a member of the engagement team)
- Regular independent internal or external quality reviews of the engagement.

e) Intimidation threat

This is the threat that a professional accountant will be prevented from performing his work objectively in view of actual or perceived pressure which includes attempts to exert undue influence over him.

Examples of circumstances which may create intimidation threats for a professional accountant who is in public service include:
(i) A firm being threatened with dismissal from a client engagement;
(ii) A firm being threatened with litigation by the client;
(iii) A firm being pressurized to reduce inappropriately the extent of work performed so as to reduce fees;
(iv) An audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction; and
(v) A professional accountant being informed by a partner of the firm that a planned promotion will not take place except the accountant agrees with an audit client's inappropriate accounting treatment.
Where the threat is serious, it may be advisable to resign from the engagement.

Self-assessment question

Identify and discuss the major ethical threats to the auditor's independence and objectivity.

3.1.3 The provision by auditors of non-audit services

In addition to the provision of accountancy or valuation services considered above, the Code recognises that there may be (or there may appear to be) a threat to objectivity and independence where the auditor provides additional, non-audit, services to the client. Such non-audit services might include:

- accounting services and services in connection with preparing the financial statements (see earlier)
- taxation work
- the 'outsourcing' of internal audit services (to the external audit firm)
- IT work
- consultancy assignments.

The provision of non-audit services is now common among audit firms of all sizes. Most auditors recognise the potential threat to their independence and they try to deal with the problem through their internal organisational structure.

- Larger firms will operate in a number of separate departments, each with its own partners and members of staff. By dividing the work of the audit firm into different functions, employees involved in audit work will not be the same as those involved in providing, say, consultancy advice to the same client.
- In some of the largest practices, the consultancy department has been legally separated from the accounting/auditing arm of the firm as a further step towards preserving auditor objectivity and independence.
- A similar approach is often taken by smaller audit firms. Although these firms may not be large enough to be organised in separate departments, efforts are usually made to ensure that different members of staff and partners are responsible for different services provided to clients.

ICAN Code of Ethics guidance on providing non-audit services

The Code recognises the value to both client and auditor of the provision of non-audit services, but requires the auditor to evaluate the significance of any threat to independence created by the provision of such services.

In some cases it may be possible to eliminate or reduce the threat by applying safeguards. However, ICAN considers that safeguards are not possible for the following activities:

- authorising or executing a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so
- determining which recommendation of the firm should be implemented
- reporting, in a management role, to those charged with governance.

All the above activities involve the auditor or audit firm in assuming a management role.

ICAN considers several specific areas of non-audit service provision. Most of these activities are considered permissible, provided that:

- management decisions are not taken and
- appropriate safeguards are put in place.

Some of these areas include:

- Taxation services - Routine compliance, planning and advisory work on taxation is generally permissible, subject to the condition that the auditor must not make management decisions.

- ❖ Internal audit services - Internal audit services may be provided by an external audit firm, if there are appropriate safeguards (e.g. use different teams for internal audit services and the audit), on condition that the auditor does not act in a management capacity, and that the client acknowledges its responsibilities for internal controls.
- ❖ IT systems services - IT systems services are permissible with appropriate safeguards. (The client must acknowledge its responsibilities and make all management decisions.)
- ❖ Litigation support services - Such services may include:
  - acting as an expert witness
  - calculating estimated damages
  - assistance with document management and retrieval and could create a self-interest threat, depending on the materiality of the amounts involved and the subjectivity of the matter concerned.

Safeguards might include:

- the service not being performed by a member of the assurance team
- the firm having policies and procedures such that an individual is prevented from making any management decision on behalf of the client
- the involvement of independent experts.
- ❖ *Legal services* - The threat will depend on the nature of the service, whether the provider is also a member of the assurance team and the materiality of the matter. Safeguards are likely to include those listed under general non-assurance services above. However, the Code states that acting for an audit client in the resolution of a dispute or litigation where the amounts involved are material to the financial statements creates such significant advocacy and self-review threats that the work should not be taken on.
- ❖ *Recruitment of senior management* - The recruitment of senior management for an assurance client may create current or future self-interest, familiarity and intimidation threats. The level of the threat will depend on the role of the person to be recruited and the type of assistance sought. The firm may review CVs and draw up a short-list of candidates for interview but the decision as to who is hired must be made by the client.

3.1.4 Commercial transactions between an audit client and a member of the audit team

The Code does not prohibit commercial transactions between an audit client and a member of the audit team, provided that:

- they are made in the normal course of the client's business;
- they are at an arm's length (in other words, they are made on normal commercial terms); and
- the value of the transaction is not material to either party.

3.1.5 Making Referrals

An audit firm may enter into an arrangement with another entity, whereby the other entity agrees to pay a fee to the audit firm for referring clients. For example a software company may specialise in selling accounting software packages. It may enter an arrangement with an audit firm whereby the audit firm will receive a fee every time that it refers a client to the software firm with a view to buying a software package or software services.

This type of arrangement could create a self-interest threat for the audit firm. However, it is permissible, provided that suitable safeguards are in place.
Suitable safeguards would include the following:

- When making a referral, the audit firm should notify the client that it will receive a fee for the referral. This means that the client will be made fully aware of the financial benefit for the audit firm.
- The audit firm should monitor the quality of the products or services provided. In the case of referrals to a software company, this means having to keep the quality of the software packages and services under review, to make sure that they meet appropriate standards.
- The firm should also obtain verification from all staff involved with the audit of a client who is referred, that they do not personally have any financial interest in the company or other entity to which the referrals are made.

Furthermore, a Chartered Accountant in public practice may purchase all or part of another firm on the basis that payments will be made to individuals formerly owning the firm or to their heirs or estates. Such payments are not regarded as commissions or referral fees.
For obtaining new clients, ICAN's code of ethics states that a Chartered Accountant in public practice shall not pay or receive a referral fee to obtain a client, for example, where the client continues as a client of another Chartered Accountant in public practice but requires specialist services not offered by the existing Chartered Accountant. The payment of such a referral fee may also create a self-interest threat to objectivity and professional competence and due care

3.2 Conflicts of Interest

Conflicts between members and clients

ICAN members or firms should not accept or continue an engagement where there is a conflict of interest between the member or firm and its client. The test is whether or not a "reasonable and informed third party" would consider the conflict of interest as likely to affect the judgment of the member or the firm.
Examples of this include:

- when members compete directly with a client
- the receipt of commission from a third party for the introduction of a client (for example, an accounting firm may be paid a commission by another entity, such as a firm of brokers, for introducing the entity to its client companies.

Safeguards

Accountant should have procedures in place to:

- identify possible conflict of interest situations
- evaluate the possible problem, and
- where necessary, take action to manage or avoid the conflict.

Possible procedures include the following:

- Review relationships with all clients on a regular basis.

- Take care to consider potential conflicts of interest when deciding whether or not to take on new clients.
- If a potential conflict is identified, decide on an appropriate course of action.

An appropriate course of action may be any of the following:

- Notify the clients involved and discuss the matter with them.
- Set up 'Chinese walls' to manage the problem. A Chinese wall is set up by using different members of staff on the assignments for each of the clients, and locating them in different offices. The two groups of staff act independently of each other, and do not communicate with each other except in an official capacity.
- Consider resigning (or declining the new engagement offered) in respect of one of the two competing clients.

Conflicts between competing clients

A firm might act for two clients that are in direct competition with each other. The firm has a professional duty of confidentiality, and so will not disclose confidential information about one client company to its competitor. Again, the test is whether a "reasonable and informed third party" would consider the conflict of interest as likely to affect the judgment of the firm. The approach that the accounting firm should take will be a matter of judgment and should reflect the circumstances of the case. Where the acceptance or continuance of an engagement would materially prejudice the interests of any client, the appointment should not be accepted or continued.

In other cases, possible safeguards might include the following:

- Giving careful consideration to whether or not it is appropriate to accept an assurance engagement from a new client that is in direct competition with an existing client, it may be appropriate to decline the offer from the potential new client.
- Careful management of the clients, for example by ensuring that different members of staff are used on the two engagements.
- Full and frank disclosure to the clients of the potential conflict, together with suitable steps by the firm to manage the potential conflict of interest.
- Procedures to prevent access to information (such as physical separation of the teams and confidential and secure data filing). Such an approach is known as creating "Chinese walls".
- Establishing clear guidelines on security and confidentiality and the use of confidentiality agreements.
- Regular review of safeguards in place.
- Advising one or both clients to seek additional independent advice

3.3 Corporate Financial Advice

Certain types of corporate finance services may create such significant advocacy and self-review threats that the work should not be taken on. Assurance firms should not:

- promote, deal in or underwrite an assurance client's shares
- commit an assurance client to the terms of a transaction or complete a transaction on an assurance client's behalf.

In other cases, safeguards such as not making management decisions and using individuals who are not members of the assurance team should be considered.

3.3.1 Advising clients involved in take-over bids or share issues

Auditors are often asked to give advice. However, where clients are involved in a contested take-over bid, the auditors could find themselves in a position where they are potentially acting for both parties. In this situation:

- there is a danger that the firm cannot give objective professional advice in the best interests of both parties (a possible lack of independence)
- the firm may be in possession of confidential information relating to each party, with a risk that the information may inadvertently become available to the other party (a possible breach of confidentiality).

Guidelines in this area are as follows:

- In principle, firms are not precluded from acting for both parties when a contested takeover bid occurs. However, a firm should not be the sole or main advisor to both parties.
- If the accountants are in possession of material confidential information and feel that their position in this respect is questionable, they should take advice from the appropriate financial regulatory authority (for example, the stock exchange involved in the take-over or the national regulator of the financial markets).

Note: Similar conflicts of interest may arise in connection with issues of shares to the public, because the accountants may be advising both the company issuing the shares and potential investors (such as companies interested in buying an investment in the shares, or investment institutions).

4.0 Conclusion

Adherence to ethical principles is fundamental to professional practice of the accountant as an auditor. Compliance with ethical principles is central to the continued integrity of the practitioner as well as the credibility of the audit report issued by him. The public's acceptance of and reliance on the auditor's work is by extension its acceptance of and reliance on the accounting profession. The auditor should therefore be wary of situations that create threats to his objectivity and independence.

5.0 Summary

This unit discussed the fundamental ethical principles as encapsulated in IFAC's Code of Ethics as well as ICAN's Rules of Professional Conduct and Guide for Members. It also examined threats to the accountant's independence and objectivity and practical situations that can bring about these threats. Possible safeguards to the identified threat are also suggested.

6.0 Tutor- marked Assignments

1. Discuss the **Five** ethical principles given by the IFAC Code of ethics.

2a. You are an audit manager in the firm of Adejare & co (Chartered Accountants). Your firm has been approached by Maylux Co. to provide the annual audit. Maylux Co. operates a chain of bookshops across the country. The shops sell stationery such as diaries and calendars, as well as new books. The financial year will end on 31 December 2015, and this will be the first year that an audit is carried out.

The potential audit engagement partner, Val Olumide, recently attended a meeting with NnannaUlu, managing director of Maylux Co regarding the audit appointment. In this meeting, Nnanna made the following comments:

"Maylux Co. is a small, owner-managed business. I run the company, along with my sister, Rita and we employ a part-qualified accountant to do the bookkeeping and prepare the annual accounts. The Accountant prepares management accounts at the end of every quarter, but Rita and I rarely do more than quickly review the sales figures. We understand that due to the company's size, we now need to have the accounts audited. It would make sense if your firm could prepare the accounts and do the audit at the same time. We don't want a cash flow statement prepared, as it is not required for tax purposes, and would not be used by us.

Next year we are planning to acquire another company, one of our competitors, which I believe is an existing client of your firm. For this reason, we require that your audit procedures do not include reading the minutes of board meetings, as we have been discussing some confidential matters regarding this potential acquisition."

Required:

Identify and explain the professional and ethical matters that should be considered in deciding whether to accept the appointment as auditor of Maylux Co. (12 marks)

b. Several audit clients have requested that Adejare & Co. provide technical training on financial reporting and tax issues. This is not a service that the firm wishes to provide, and it has referred the audit clients to a training firm, Maggie Johnson Consultants, which is paying a referral fee to Adejare & Co. for each audit client which is referred.

Required:

Identify and evaluate the ethical and other professional issues raised, in respect of Maggie Johnson Consultants. (3 marks)

(Total: 15 marks)

(ACCA Adapted)

3. ICAN has an ethical guide, its Professional Code of Conduct and Guide for Members. These rules are applicable to all members. If these rules are not complied with, disciplinary action may result which could lead to a reprimand, fine or delisting.

Required:

a. Explain why you think ICAN's fundamental principles are so important to auditing. (6 marks)

b. Explain how a member can demonstrate that he is truly independent in carrying out the work he performs and why it is important that he should do so. (6 marks)

c. Set out the circumstances under which it is permissible to disclose confidential client's information. (8 marks)

(Total 20 Marks)

(ICAN May 2015)

7.0 References/further reading

1. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.

2. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International

3. Hayes, R et al (2005), Principles of Auditing: An introduction to international standards on auditing. England: Prentice Hall (Pearson Education Publishers).

UNIT 4: AUDITOR'S PROFESSIONAL LIABILITY

Content

1.0 Introduction

The audit work is a contract of service with its attendant responsibilities and risks, which do give rise to liabilities. The liability may be criminal or civil, and this implies that the auditor needs to carry out his assignment with an appropriate skill set, competence and due diligence.

This chapter deals with the auditor's liability and in discussing this, some decided cases on auditor's liability are examined.

2.0 Objectives

By the end of this unit, you should be able to:

- Discuss the legal position of the auditor
- Explain some decided cases l on the liability of the auditor and evaluated whether such judgments could be taken as judicial precedents today.
- Discuss some steps/actions an auditor may take to avoid/reduce exposure to litigation
- Appreciate the need for the auditor to apply appropriate skill set, competence and due care in the discharge of his assignments.

3.0 Main Content

3.1 LEGAL POSITION OF THE AUDITOR

The auditor's responsibility to clients and other users of the financial statements (third parties) in tort and contract can give rise to liability, particularly in the event of negligence. Because their work is relied upon by others in taking economic decisions with pecuniary implications, auditors clearly have a responsibility to do their work honestly and carefully. The clauses used are "reasonable care and skill" and an attitude of "professional skepticism" in carrying out his work. The judge in the London and General Bank case (1895) summed it up this way: "He must be honest – that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

And Lord Denning in the case of Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd 1958 sought to define the auditors' proper approach to their work by saying:

'... they must come to it with an inquiring mind - not suspicious of dishonesty .... - but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.'

What "reasonable care and skill" actually means depends on circumstances. Case law on this matter is complex. In some cases, auditors are held liable to third parties and in others, they are not so held. However, auditor's liability is a dynamic issue. It evolves as cases are brought to court.

3.2 Professional Liability

Professional accountants may have professional liability under Common law as well as under statutory law. The liability may be criminal or civil (arising out of contract and tort).

Criminal Liability

Criminal liabilities arise out of statute. Under section 560 of CAMA, if any person in any return, report, certificate, balance sheet or other document required for the purpose of any provisions of the Act, willfully makes a statement that is false in any material particular, knowing it to be false, he is criminally held liable and may be imprisoned (2 years), if convicted by a High Court or fined (N1,000), or 4 months imprisonment, if convicted by a lower court or both such fine and imprisonment.

Under sect. 436 of Nigerian Criminal Code, if any promoter, director, officer or an auditor of a company makes, circulates, publishes or concurs in making, circulating of publishing of any statement or account, false in any material particular, and intended to deceive or defraud, any person to invest in such a company, he is guilty of felony and liable to 7 years imprisonment.

Generally and under various other statutes, auditors may be liable under criminal law if found guilty:

- ❖ Insider dealing, since they are privy to inside information
- ❖ If they knew or suspected a client was laundering money and they failed to report to the appropriate authority
- ❖ If found to be aiding and abetting criminal activity. Arthur Andersen was found guilty for blocking investigation by shredding vital documents in the case of Enron.

Under **insolvency/winding up of companies,** auditors may be found to be officers of the company and could be charged with criminal offences or found liable for civil offences in connection with the winding up of the company (see CAMA, sects. 502, 503). Criminal liability can also arise for offences relating to tax law.

Civil Liability

Civil liabilities may arise under contract or in tort.

Liability under Contract

The audit client, the company has a contract with the auditor. A contract for the supply of service, such as audit, has a duty of care implied in it by statute, that is, duty of care is automatic and needs no proof. In a case of this nature only **two elements** need proving, namely:

- ❖ Whether the duty of care has been breached and
- ❖ Whether any loss has arisen as a result of the breach.

Sect. 368(1), CAMA Cap C20, LFN 2004 states, “ 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.

(2) Where a company suffers loss or damages as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by subsection (1) of this section, the auditor shall be liable for negligence and **the directors** may institute an action for negligence.

(3) If the directors fail to institute an action against the auditor under subsection (2) of this section, any member may do so after the expiration of 30 days’ notice to the company of his intention to institute such an action.

Key Issues of This Provision

1. Duty of Care: This is the obligation to exercise a level of care, as is reasonable in all circumstances, in carrying out professional work. In the case of an audit, it is a level of care and competence that will help to minimize the risk of material errors or misstatement in the financial statements.

Different judgments made in law cases show how the auditors' duty of care has been gauged at various points in time. Legislation often does not state clearly the manner in which the auditors should discharge their duty of care. It is also not likely that this would be clearly spelt out in any contract setting out the terms of an auditors' appointment. Although the articles of a company may extend the auditor's responsibilities beyond those envisaged by the Companies Act, they cannot be used so as to restrict the auditor's statutory duties. Such provisions, where they exist may not also place any restriction upon the auditor's statutory rights which are designed to assist him in the discharge of those duties.

Lopes L J gave an insight into how best to consider/gauge the degree of skill and care required of an auditor in *Re Kingston Cotton Mill Ltd (1896):*

'... it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution, must depend on the particular circumstances of each case.'

For Lopes, what constitutes reasonable care depends very much upon the **facts** of a particular case.

Another criterion by which the courts will determine the adequacy of the auditors' work is by assessing it in relation to the generally accepted auditing standards of the day. Thus, a measure of good practice is now available for the courts to take into account for they will be very much concerned with accepted advances in auditing techniques. This was demonstrated by Pennycuick J in *Re Thomas Gerrard & Son Ltd 1967* where he observed:

'... the real ground on which *Re Kingston Cotton Mill*... is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896.'

Lord Denning in the case of *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd 1958* sought to define the auditors' proper approach to their work by saying:

'... they must come to it with an inquiring mind - not suspicious of dishonesty .... - but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.'

If the auditors' suspicions are aroused, they must conduct further investigations until such suspicions are either confirmed or allayed. The auditors have a responsibility to keep themselves abreast of professional developments. Auditing Standards are likely to be taken into account when the adequacy of the work of auditors is being considered in a court of law or in other contested situations. But note that only a negligent act will be regarded as a "breach of the duty of care"

2. Negligence

.Negligence is defined as an act or omission which occurs because the person concerned (e.g. an auditor) failed to exercise that degree of reasonable skill and care which is reasonably to be expected in the circumstances of the case.

Negligence is a common law concept. It seeks to provide compensation to a person who has suffered loss as a result of another person's wrongful neglect. To succeed in action for negligence, an injured party must prove 3 things:

1. That a duty of care existed.
2. The duty of care was breached by the defendant(auditor) and
3. The breach caused the claimant (the injured party) a pecuniary (financial) loss.

As an appointed agent of shareholders, an auditor must exercise reasonable care and skill in carrying out his duties as any breach of such duty will occasion pecuniary harm to his principal – the shareholders.

Some of the cases dealing with auditors' liability under contract include:

- Re London and General Bank (1895)
- Re Kingston Cotton Mill (1896)
- The London Oil Storage Co. Limited v. Seear, Hasluck & co. (1904)
- Re Westminster Road Construction and Engineering Co. Ltd (1932)
- McKesson and Robbins (1939)
- Re Thomas Gerrard& Son (1968)

Self-assessment questions

1. Under what circumstances will an auditor be criminally liable for his actions?
2. Discuss the liabilities of the auditor under contract and in tort.

3.3 CASE LAWS

1. RE LONDON AND GENERAL BANK (1895)

Facts of the Case

The bank had advanced loans to customers backed by insufficient collaterals (securities). Bank took credit for interest accrued on these loans and paid dividends out of spurious profits (invariably out of capital). Adequate provisions were not made for bad debts and non-performing credits. The auditor apparently was aware of the real state of affairs and reported fully to the directors who refused to alter the accounts. In his report to the shareholders, the auditor made no mention of the deficient security etc. but merely stated, "the value of the assets shown by the balance sheet is dependent upon realization." The bank failed and one of the principal reasons for the failure was the heavy loss in respect of these loans.

Held: Auditor was guilty of misfeasance and thus jointly and severally liable with the directors in respect of two dividends declared, amounting to some 14,400 pounds, on the ground that he ought to have reported the true facts to the shareholders.

The judge made the statement: "the auditor's business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is by examining the books of the company. But he does not discharge his duty by doing this without enquiry and without taking the trouble to see that the books and records of the company show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than an idle farce."

2. RE KINGSTON COTTON MILL (1896)

Facts of the case

The accounts of the company were falsified by the MD by means of extensive stock over-valuation. The auditors accepted the stock valuation certificates issued by the MD. False profits were thus declared and dividends were paid out of capital.

Held: That the auditors, though deceived were not wanting in skill, care or caution in accepting the figures of the MD and thus not liable for the dividends paid out of capital.

The Judge, Lopes (1896) said, "it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case…. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion… so to hold would make the position of the auditor intolerable.

Note: Opinion and practice have greatly changed since this case was decided, and thus, it is not a valid precedent today. An auditor acting literally on this decision will be running a great risk. By the provisions of ISA 240, "The Auditors' responsibility to consider fraud in an audit of financial statements", auditors today have to recognize at least the possibility that fraud may exist and approach his work with an attitude of 'professional scepticism'.

3. RE THOMAS GERRARD & SONS (1968)

Facts of the case

For many years the MD of the company falsified stock figures in the accounts in order to conceal losses and to enable dividends to be paid. To do this he included non-existent stock and he also altered some invoices, which were discovered by the auditors, but not investigated of followed up. The auditors relied on the stock certificates issued by the MD and contended that it was not part of their role to take stock but merely to verify the figures and that they were entitled to rely on the assurances given by a responsible official of the company.

Held: That the altered invoices had put the auditors 'on inquiry' and they should have investigated the matter.

The Judge, PennyCuick (1968) observed, '... the real ground on which *Re Kingston Cotton Mill*... is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896.'

Note: The courts are today concerned with accepted advances in auditing techniques. Therefore, if the auditor's suspicions are aroused, they must conduct further investigations until such suspicions are either confirmed of allayed.

Liability to third parties in Tort

For many years, it was thought that there could be no liability to a third party in the absence of a contractual relationship – Candler v. Crane Christmas & Co.(1958). However, in the case of Donoghue v. Stevenson (1932), damages were awarded in favour of a young lady who consumed the contents of a ginger beer bottle in a seaside café only to discover later that the contents included the decomposed remains of a snail. Although the contractual relationship was between her and the vendor of the bottle, damages were awarded against the manufacturer, with whom there was no such relationship.

However, it is pertinent to note that the law of tort has established that a person owes a duty of care and skill to 'our neighbours'. But this duty of care is not implied, since there is no contract between the third party and the auditor, and must therefore be established or proved.

In the context of the professional auditor the wider implications, however, concern the extent to which the auditor owes a duty of care and skill to third parties who rely on financial statements upon which he has reported but with whom he has no direct contractual or fiduciary relationship.

The general view of the law in this regard was expounded by Lord Morris, in Hedley Byrne v. Heller & Partners (1963) when he said: "I consider… that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the benefit of another person who relies on such skill, a duty of care will arise…." This case established further that if in a sphere in which a person is so placed that others could reasonably rely on his judgment or his skill or on his ability to make careful inquiry, a person who takes it on himself to give information or advice to or allows his information or advice to be passed on to another person who, as he knows or should know, will rely on it, then a duty of care will arise. Thus a duty of care arises whenever a professional is aware of the identity of a third party and knows or ought to know that the third party will rely on his skill/opinion for his decisions.

In *Caparo Industries plc v Dickman & Others 1990*, it was established that for this duty of care to arise, (i) harm must be reasonably foreseeable and (ii) a relationship of 'proximity' between the third party and auditor must exist. It was thus held that the auditors of a public company's accounts owed no duty of care to members of the general public who relied upon the accounts in deciding to buy shares in the company.

The recent Scottish Bannerman case (Royal Bank of Scotland v. Bannerman Johnstone Maclay & Ors 2002) suggests that judges may be more likely to impute a duty of care to the auditors if they were aware that a third party (eg a bank) made use of audited accounts and did not disclaim liability to them.

Interesting Cases in this area include:

- Hedley Byrne & co. Ltd v. Heller & Partners Ltd (1963)
- JEB Fasteners v. Marks, Bloom & co. (1980)
- Credit Alliance v. Arthur Andersen & co. (1985)

- ❖ Caparo Industries v. Dickman & Touche Ross & co. (1990)
- ❖ ADT Ltd & BDO Binder Hamlyn (1995)
- ❖ Peach Publishing co. v. Slater & co. (1997)
- ❖ Royal Bank of Scotland v. Bannerman Johnstone Maclay & Ors (2002).

1. HEDLEY BYRNE CO. LTD V. HELLER & PARTNERS LTD(1963)

Facts of the Case

The plaintiff (Hedley Byrne) lost money when a bank reference was negligently produced; the bank indicated that their client was a good credit risk when this was not the case.

Held: That in principle, though there was no contract between Hedley Byrne and the bank. The bank was liable to pay damages because of its negligence.

The Key Point:

If a third party could show that it relied on the work of another (e.g. an auditor), which turned out to be wrong, the third party could claim damages, provided that the identity of the third party was known to the professional at the time of doing the work.

The Judge, Lord Morris said: "I consider … that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the benefit of another person who relies on such skill, a duty of care will arise…. Furthermore, if in a sphere in which a person is so placed that others could reasonably rely on his judgment or his skill or on his ability to make careful inquiry, a person who takes it on himself to give information or advice to or allows his information or advice to be passed on to another person who, as he knows or should know will place reliance on it, then a duty of care will arise."

Note: The established damages in this case were not paid because the reference letter contained a general disclaimer of liability.

2. JEB Fasteners v Marks Bloom (1980)

In this case, the plaintiff acquired the share capital of a company. The audited accounts, due to the negligence of the auditors, did not show a true and fair view of the state of affairs of the company. It was accepted that, at the time of the audit, the defendant auditors did know of the plaintiffs, but did not know that they were contemplating a take-over bid.

Held: Whilst recognising that the auditors owed a duty of care in this situation, the court decided that the auditors were not liable because the plaintiff had not actually suffered any loss. It was proved that the plaintiffs would have bought the share capital of the company at the agreed price, no matter what the accounts of the company had shown.

3. CREDIT ALLIANCE V. ARTHUR ANDERSSEN & CO. (1985)

This case also tries to establish if an auditor may be held liable, in the absence of privity of contract, to a third party who relies to his detriment upon a negligently prepared report.

Facts of the Case

The plaintiffs, Credit Alliance were providers of credit (loans) to L.B Smith, to finance its capital intensive enterprise. In 1978, Credit Alliance advised Smith that as a condition to extending further credit, they required their audited financial statements. Smith provided their 1977 financial statements certified true and fair by Arthur Andersen and co. On the strength of these financial statements and those of 1979 on further request by the plaintiff, Credit Alliance provided substantial amounts in financing to L.B Smith. It was alleged that both statements over-stated Smith's assets, net worth and general financial health and that Andersen failed to conduct investigations in accordance with proper accounting standards, in order to discover Smith's precarious financial health.

In 1980, Smith filed a petition for bankruptcy. Credit Alliance instituted an action against Arthur Andersen for damages on its loan losses, alleging negligence and fraud. Credit Alliance alleged that Andersen knew, should have known or was on notice that the financial statements were being used by Smith to induce companies to extend credit to it. Also, that Andersen knew or recklessly disregarded facts indicating that the financial statements were misleading.

Held: The claimant failed to establish contractual privity between it and Andersen or a relationship sufficiently close to that of privity. Also, no proof could be established that Andersen was aware beforehand that Credit Alliance would rely on its certification. Case was dismissed in favor of Arthur Andersen.

4. CAPARO INDUSTRIES PLC V. DICKMAN & ORS (1990)

In this case, the House of Lords established that for one party to owe a duty of care to another, the following must be established:

- Harm must be a 'reasonably foreseeable' result of the defendant's conduct;
- A relationship of 'proximity' between the defendant and claimant must exist; and
- It must be 'fair, just and reasonable' to impose liability.

Facts

In 1984, Caparo Industries purchased 100,000 Fidelity plc shares in the open market. On June 12, 1984 the date on which the accounts done with the help of accountant Dickman and audited by Touche Ross, were published, Caparo Industries bought a further 50,000 shares. Relying on the accounts, further shares were acquired, bringing its holdings in Fidelity to 29.9%. On Sept. 4, Caparo made a bid for the remainder and by October 1984, it had acquired control of Fidelity.

Caparo alleged that the accounts on which it had relied were misleading in that an apparent pre-tax profit of some 1.3 million pounds should in fact have been shown as a loss of over 400,000 pounds. The Plaintiffs argued that Dickman/Touche Ross owed a duty of care to investors and potential investors.

In February 1990, the House of Lords reached the following conclusion:

- That the auditors of a public company's accounts owed no duty of care to members of the public at large who relied upon the accounts in deciding to buy shares in the company. As a purchaser of further shares, while relying on the auditors' report, a shareholder stood in the same position as any other investing member of the public to whom the auditor owed no duty.
- The purpose of the audit was simply that of fulfilling the statutory requirements. There was nothing in the statutory duties of company auditors to suggest that they were

intended to protect the interest of investors in the market. And in particular, there was no reason why any special relationship should be held to arise simply from the fact that the affairs of the company rendered it susceptible to a takeover bid.

Note: The auditor needs to be cautious in relying fully on this judgment considering the re-definition of the primary users of public interest entity financial statements as **existing and potential investors, lenders and other creditors** by the IASB Conceptual Framework on financial reporting. In addition to the statutes, the courts tend to consider best practices and developments in the profession.

5. **ROYAL BANK OF SCOTLAND V. BANNERMAN, JOHNSTONE MACLAY & ORS (2002)**

Facts of the Case

The bank provided facility to the company being audited. In 1998, the company went into receivership with debts around 1.3 million Pounds owing to the Royal Bank of Scotland (RBS). RBS claimed that due to a fraud, the accounts of previous years had misstated the true financial position of the company and the defendants (the auditors) have been negligent in not detecting it.

A requirement of the lending agreement was that monthly management accounts and audited accounts were to be sent to the bank as soon as practicable. The auditors claimed they had no duty of care to the bank.

Held: The auditors were liable on the basis that they knew the identity of the third party, the use to which the information would be put and that the bank intended to rely on it for the known purpose.

Note: Significantly, the Judge commented that the auditors having become aware of the details of the lending agreement could have issued a disclaimer to the bank. The fact that they did not was an important factor in deciding that the auditors did owe a duty of care to the bank.

3.4 Litigation avoidance

Generally, the strategy being adopted by auditors to avoid litigation has various aspects which encompass:

1. **Client acceptance procedures**

Firms should carefully assess the risk associated with potential audit clients. Screening procedures should be used to identify matters that create potential exposure for the audit firm. For example, it would be unwise to take on a new client with significant going concern problems. The issue is that a client should only be accepted if the associated risk can be managed to an acceptably low level given the skills and resources of the audit firm.

2. **Proper use of engagement letters**

The engagement letter should be used to clearly state the responsibilities of the auditor, and of management. As it forms a contract between the audit firm and the client, it should be updated on an annual basis, with care being taken to ensure the client is fully aware of any changes in the scope of the audit, or the reporting responsibilities of the audit firm.

3. **Performance and documentation of audit work**

Audit firms should ensure that professional standards are maintained, and that International Standards on Auditing (ISAs) are adhered to. It is crucial that full documentation is maintained for all aspects of the audit, including planning, evaluation of evidence, and consideration of ethical issues. A claim of negligence is unlikely to be successful if the audit firm has documentary evidence that ISAs have been followed.

4. **Quality control**

Firms must ensure they have implemented firm-wide quality control procedures, as well as procedures applicable to the individual audit engagement. Quality control acts as an internal control for the audit firm, helping to ensure that ISAs and internal audit methods have been followed at all times.

5. **External consultations**

Firms should make use of external specialists when the need arises, for example obtaining legal advice where appropriate, to ensure that the auditor's actions are acceptable within the legal and regulatory framework.

6. Disclaimers

In recent years it has become common in some jurisdictions for audit firms to include a disclaimer paragraph in the audit report. This is an attempt to restrict the duty of care of the audit firm to the shareholders of the company, thereby attempting to restrict legal liability to that class of shareholders. Disclaimers, however, may not always be effective.

7. **Professional indemnity Insurance**

Professional indemnity insurance should be taken out to cover the firm against possible claims. Some accounting professional bodies make this a requirement for the renewal of members' practicing licence.

However, the best way of restricting liability is for auditors to carry out their audit work in accordance with auditing standards. Where work is properly conducted the auditor should not need to subject it to blanket disclaimers.

3.5 Out-of-court settlements

Many cases/claim against auditors are not widely publicised, often because they are settled 'out of court'. This involves the parties who are in dispute reaching a negotiated settlement, rather than taking their case to court.

The *advantages* of out-of-court settlements are that:

- it avoids the cost and time involved in a court case
- it may avoid adverse publicity for the auditor
- the final settlement may be lower (because both sides save legal costs, and the plaintiff might agree to a lower settlement to avoid the cost and the risk of losing the case).

The *disadvantages* of out-of-court settlements are that:

- the final responsibility may be left undecided, so the legal position remains unclear
- it may encourage others to take action against auditors
- insurance premiums may rise

4.0 Conclusion

The auditor's works give rise to liability under statute and common law. It could be criminal liability or civil liability arising from negligence. Guidance from the professional bodies have suggested ways of mitigating the negative effect of such liabilities and the auditor is encouraged to adopt such steps in his professional practice.

5.0 Summary

This unit generally explained the legal position of the auditor, reviewed some decided cases under contract law and tort; examined some strategies an auditor can adopt to avoid or mitigate the effect of litigation and finally considered the advantages and disadvantages of out-of-court settlement.

6.0 Tutor-marked Assignment

1. Although auditors can incur civil liability under various statutes, it is far more likely that they will incur liability for negligence under the Common law. Auditors must be fully aware of the extent of their responsibilities, together with steps they must take to minimize the danger of professional negligence claims.

Required

a. Briefly discuss the extent of auditors' liability/responsibilities to shareholders and others during the course of their normal professional engagement. (10 marks)
b. Explain any five steps which auditors should take to minimize the danger of claims against them for negligent work. (5 marks)
c. Explain the advantages and disadvantages of out-of- court settlement (5 marks)

(Total 20 Marks)
(ACCA adapted)

2. In each of the cases below, you are required to sate the facts of the case, the judgments given and whether judgments can be relied upon in similar cases today:

i. Re Kingston Cotton Mill (1896)
ii. Re Thomas Gerrard & Sons (1968)
iii. Caparo Industries Plc V. Dickman & Ors (1990); and
iv. Royal Bank of Scotland V. Bannerman, Johnstone Maclay & Ors (2002)

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST
2. FGN, Companies and Allied Matters Act, cap C20 LFN 2004
3. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media

UNIT 5: AUDIT EXPECTATION GAP; FRAUD AND ERROR

Content

1.0 Introduction

The perceptions of users of auditor's services regarding auditor's responsibilities are wide and varied and go beyond roles/responsibilities of the auditor as assigned by statute and the profession. These misconstrued roles of the auditor by the public have come to be known as the audit expectation gap. Such gaps exist in many areas of the auditor's work including the responsibilities of the auditor regarding fraud and errors in his audit of financial statements.

2.0 Objective

By the end of this unit, you should be able to:

- Explain the meaning and types of audit expectation gap
- Evaluate the steps being taken by the accounting profession and legislation to reduce audit expectation gap
- Explain the difference between fraud and error and the types of fraud that cause misstatement in financial statements
- The responsibilities of management and the auditor in fraud prevention/detection.
- Identify fraud risk factors in a given scenario
- Explain the auditor's procedures as well as communication responsibility when fraud is suspected/found in financial statements
- Explain the role of professional skepticism in fraud prevention/detection

3.0 Main Content

3.1 AUDIT EXPECTATION GAP

Users of audit services have expectations regarding the duties/responsibilities of the auditor that far exceed the current practice in the profession and indeed beyond the scope/bounds defined by the statutes and Standards. While many people believe that it is the auditor's responsibility to keep the books, prepare the accounts, deal with tax matters, prevent and detect fraud etc, only very few understand the statutorily restricted role of the auditor. This misconceived role of the auditor by the public is referred to as AUDIT EXPECTATION GAP. The expectation gap is thus the gap between what users of auditor's reports believe to be the purposes of the audit compared with the actual nature of the assurance reported to them by auditors.

ISA 200/NSA 1 – *Objective and General Principles Governing an Audit of Financial statements*, paragraph 8 defines the roles of management and auditor with respect to financial statements: " While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and fairly presenting the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity, with oversight from those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities."

Expectation gaps can be viewed from two dimensions, namely, Communication gap and Performance gap.

Communication Gap: This arises as a result of a misunderstanding of the role of the auditor and the information conveyed by the auditor's report.

Many users misinterpret the content of the auditors' report and misconstrue it to mean that

- Unqualified audit opinion is a certification of the financial health of the company(a clean bill of health)
- Auditors guarantee the continued existence of the company
- Auditors issue financial statements after the audit
- All fraud, errors and other irregularities ought to have been discovered by the audit.

To reduce the communication gap, auditors' reports and annual reports presented to shareholders are being greatly enhanced. The recommendations of the Treadway Commission, reduced in CAMA, Cap C20, LFN 2004 feature in auditor's report. That is, that

a. Management has responsibility for the preparation of the financial statements.
b. It is the responsibility of Management to establish, implement and maintain adequate internal and accounting controls for safeguarding the assets of the company and for preventing frauds, errors and other irregularities.

c. It is management's responsibility to confirm suitability of accounting policies, ensure their consistent application and make reasonable prudent judgments and estimates in the preparation of financial information.
d. It is management's responsibility to confirm that standards have been followed in the preparation of the fin. Statements.
e. The auditor's report explains the basis of opinion and the audit approach.

To further reduce the communication gap, and following the provisions of the Sarbanes-Oxley Act, 2002, the annual reports currently feature as part of the financial statements

a. Statement of Directors' responsibilities(Sample 1 below)
b. Certification by the CEO and the CFO to the "appropriateness of the financial statements and disclosures contained in the report and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition" of the company (sample 2).

Performance Gap

In performance gap, public expectation is reasonable, the auditor's opinion is not misinterpreted but the auditor's performance fell short of the required standard. For example, the auditor has compromised his integrity and independence, inadequate technical skills and competence have been employed etc. Most of the high profile corporate and audit failures fall within this category.

The controls put in place by ICAN and other International Professional Bodies (eg IFAC) to reduce this gap include:

a. Establishment of Professional Practice Monitoring Committee (PPMC)
b. Introduction of CPE and MCPE
c. Establishment of technical Committees by the professional bodies that serve as reference to members on technical issues.
d. Establishment of disciplinary tribunals that try and sanction erring members
e. Enhancement of Education programmes of Accountants-in-training through syllabus reviews.
f. Maintenance of technical libraries by the professional bodies.

Other controls include:

i. The establishment of the audit committee
ii. Fora provided by the AGMs where shareholders can ask questions on the audited accounts.
iii. Judicial precedents and pronouncements on audit matters/negligence and failures that go to court.
iv. The role of Govt. in setting and monitoring standards through the FRCN etc.

Expectation gap may also be seen as comprising of three main elements:

A **standards gap**. This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that auditors have wide-ranging rules that they must follow.
A **performance gap**. This occurs because of a perception that audit work has fallen below the required standards.
A **liability gap**. This arises from a lack of understanding about the auditor's liability and who the auditor may be liable to.

3.1.1 Common Areas of Expectation Gaps

Different groups have different expectations with regard to an auditor's duties. Expectations are found in the following areas of auditor's duties:

1. **Giving an Opinion on the fairness of financial statements** - Expectation gap is wide in this area. A large percentage of users of audit services expect that financial statements with an unqualified audit opinion are completely free from errors and misstatements. The inherent limitations of auditing expressed in materiality and audit risk are not entirely accepted and/or understood by all groups of users.
2. **Giving an Opinion on the Company's Going Concern status –** Auditorsgenerally need to determine whether the entity audited is able to continue as a going concern. If there are serious doubts about this, both the financial statements and the auditor's opinion need to express these doubts. But auditors generally face a dilemma in situations of this nature. It is appropriate to warn users of financial statements about threats of distress but such disclosure, especially when future course of events is hard to predict (e.g. close calls), may put management in a difficult situation in their attempt to rescue a company that could be saved.
3. **Giving an Opinion on the company's internal control –** Auditing standard requires the auditor to obtain an understanding of the company's accounting and internal control systems, sufficient to plan the audit and develop an effective audit approach. It does not require him to test the adequacy of the internal controls**.** But public expectations are high on auditor's role in testing whether a satisfactory system of internal control is being operated. These expectations exceed the auditor's current duties.
4. **Giving an Opinion on the occurrence of Illegal Acts –** Users of audit services expect the auditor to detect and report illegal acts that have a significant impact on the financial statements. But ISA 250/NSA 6 – *Consideration of Laws and Regulations in the Audit of Financial Statements,* restricts the responsibility of the auditor to designing and executing the audit in a way that there is a reasonable expectation of detecting material illegal acts which have a direct impact on the form and content of the financial statements. The Auditor reports the illegal act through the audit report and to those charged with governance as well as to the regulatory authorities and anti-crime/corruption Agencies if so required by the laws. The auditor is not expected to report to the general public/third parties.

5. **Giving an Opinion on the occurrence of fraud**

   The audit expectation gap is frequently associated with the fraud issue. The Government and all users of audit services expect the auditor to find existing fraud cases and report them. Thus, misunderstanding of the auditor's responsibilities in respect of fraud has become a major component of the 'expectation gap'. This aspect of the expectation gap is the subject of ISA 240/NSA 5 *The auditor's responsibility to consider fraud in an audit of financial statements*. By the provisions of this standard, the responsibility for the prevention and detection of fraud rests with directors and management of the entity.
   But the standard also sets out the key requirements for an auditor with regard to fraud.

Sample 1

STATEMENT OF DIRECTORS' RESPONSIBITIES, For the year ended…….

The Directors are responsible for the preparation of the Financial Statements, that give a true and fair view of the state of affairs of the Company at the end of each financial year and of the profit or loss for that year and comply with the requirements of the Companies and Allied Matters Act, cap C20, LFN 2004. In doing so, they ensure that:

- Adequate control procedures are instituted which, as far as is reasonably possible, safeguard the assets and prevent and detect fraud and other irregularities;
- Ethical standards are maintained and that the company complies with the laws of Nigeria and the Code of Corporate Governance;
- The terms of reference and procedures of all board committees are determined;
- Proper accounting methods are maintained;
- Applicable accounting standards are adhered to;
- Suitable accounting policies are adopted and consistently applied;
- Judgments and estimates made are reasonable and prudent;
- The going concern basis is adopted, unless it is inappropriate to presume that the company will continue in business.

The directors accept responsibility for the preparation of these financial statements, which have been prepared in compliance with:

- The provisions of CAMA
- The provisions of the FRCN, Act No.6, 2011;
- The published accounting and financial reporting standards issued by the FRCN
- The regulations of the Securities and Exchange Commission and the NSE.

The Directors have made an assessment of the company's ability to continue as a going concern based on the supporting assumptions stated in the financial statements, and have every reason to hold that the company will remain a going concern in the financial year ahead.

Chairman   Managing Director.

Sample 2.

CERTIFICATION PURSUANT TO SECTION 60(2) OF INVESTMENT AND SECURITIES ACT NO.29 OF 2007

We the undersigned hereby certify the following with regards to our twelve months financial report for the year ended………………….. that:

(a) We have reviewed the report;
(b) To the best of knowledge, the report does not :
    i. Contain any untrue statement of a material fact, or
    ii. Omit to state a material fact, which would make the statements misleading in the light of the circumstances under which such statements were made
(c) To the best of our knowledge, the financial statement and other financial information included in the report fairly present in all material respects the financial condition and results of operation of the company as of, and for the periods presented in the report.
(d) We:
    i. Are responsible for establishing and maintaining internal controls;
    ii. Have designed such internal controls to ensure that material information relating to the company is made known to such officers and others within those entities particularly during the period in which the annual reports are being prepared;
    iii. Have evaluated the effectiveness of the company's internal controls as of date and within 90 days prior to the report;
    iv. Have presented in the report our conclusions about the effectiveness of our internal controls based on our evaluation as of that date.
(e) We have disclosed to the auditors of the company and the audit committee:
    i. All significant deficiency in the design or operation of internal controls which would adversely affect the company's ability to record, process, summarize and report financial data and have identified for the company's auditors any material weakness in internal controls; and
    ii. Any fraud, whether or not material, that involves management or other employees who have significant role in the company's internal controls;
(f) We have identified in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of our evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Managing Director/CEO   Finance Director/CFO

Self-assessment questions

1. Explain the following terms:

- Communication gap
- Performance gap
- Standards gap; and
- Liability gap

2. Discuss the responsibilities of management with regard to the financial statements of their company.

3.2 THE AUDITOR AND FRAUD AND ERROR IN THE AUDIT OF FINANCIAL STATEMENTS (ISA 240)

3.2.1Definitions

Fraud is an intentional act by one or more individuals among management, those charged with Governance (management fraud), employees (employee fraud) or third parties involving the use of deception to obtain an unjust or illegal advantage. Fraud may be perpetrated by an individual or in collusion with people internal or external to the business.
Fraud is a wide legal concept, but the auditor's main concern is with fraud that causes a material misstatement in financial statements. It is distinguished from error, which is when a material misstatement is caused by mistake, for example, in the application of an accounting policy.

ISA 240 specifically two types of fraud causing material misstatement in financial statements:
- Fraudulent financial reporting
- Misappropriation of assets

Fraudulent financial reporting
This entails intentional misrepresentation of financial information, whereby financial information that do not reflect the economic reality of transactions and events that took place within the reporting period are presented.
This may include:
- Manipulation, falsification or alteration of accounting records/supporting documents
- Misrepresentation (or omission) of events or transactions in the financial statements
- Intentional misapplication of accounting principles

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively, for example, by recording fictitious journal entries or improperly adjusting assumptions or estimates used in financial reporting.
Aggressive earnings management in its extreme may constitute fraudulent financial reporting. Auditors should consider issues such as unsuitable revenue recognition, accruals, liabilities, provisions and reserves accounting and large numbers of immaterial breaches of financial reporting requirements to see whether together, they constitute fraud.
Misappropriation of assets
This is the theft of the entity's assets (for example, cash, inventory etc). Employees may be involved in such fraud in small and immaterial amounts, however, it can also be carried out by management for larger items who may then conceal the misappropriation, for example by:
- Embezzling receipts (for example, diverting them to private bank accounts)
- Stealing physical assets or intellectual property (inventory, selling data)
- Causing an entity to pay for goods not received (payments to fictitious vendors)
- Using assets for personal use

Error may be defined as unintentional misapplication of accounting policies, oversights, unintentional clerical mistakes, or unintentional misinterpretation of facts.

The key distinction between fraud and error is therefore whether the effect on the financial statements is deliberate (fraud) or unintentional (error). However, there may be little or no difference between fraud and error as far as the impact on the audit is concerned. In both cases the auditor will be concerned about the impact on the 'true and fair view' presented by the financial statements.

The main difference between fraud and error may arise in relation to any national reporting requirements. There may be requirements to report suspicions of fraud, but not error**.**

3.2.2 Responsibilities with regard to fraud and error

Management and those charged with governance in an entity are primarily responsible for preventing and detecting fraud.

Auditors are responsible for carrying out an audit in accordance with international auditing standards, one of which is ISA 240/NSA 5 *The auditor's responsibility to consider fraud in an audit of financial statements*.

Responsibilities of management: Management is responsible for preparing financial statements that show a 'true and fair view'. This role is reinforced by principles of good corporate governance, which require management to set up appropriate internal control systems and corporate governance systems. Management is therefore responsible for the prevention and detection of fraud and error. This is usually effected by having a commitment to creating a culture of honesty and ethical behaviour and an active oversight by those charged with governance.

Responsibilities of the Auditor

The auditor is responsible for reporting on whether the financial statements are fairly presented. He is concerned with fraud and error that has a material effect on the true and fair view of the financial statements. His responsibility therefore is to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Though audit may act as a deterrent to fraud, it is not the auditor's primary responsibility to prevent or detect fraud.

Some frauds or errors may go undetected during an audit due to the inherent limitations in any audit. The risk of not detecting a material misstatement from fraud is higher than from error because of the following reasons:

- the fact that there may be deliberate and sophisticated schemes to conceal fraud from the auditor.
- Fraud may be perpetuated by individuals in collusion
- Management fraud is harder to detect because management is in a position to manipulate accounting records or override controls.

3.2.3 Professional Scepticism and Fraud

The auditor is required to maintain professional skepticism throughout an audit.
Professional scepticism refers to "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence."
ISA 240/NSA 5 *The auditor's responsibility to consider fraud in an audit of financial statements* requires that the auditor should maintain an attitude of professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

Though past experience with the entity about the integrity and honesty of management and those charged with governance is important, there could be changes in circumstances that may necessitate the maintenance of an attitude of professional scepticism.

However, the auditor is entitled to take documents on face value unless he has reason to believe otherwise. Where the auditor's suspicion is aroused, then he should make further enquiry to confirm or allay his suspicion.

In the light of the above it is important that:

i. The audit team should discuss the possibility of fraud in the context of the specific characteristics of the audit engagement.
ii. Discussions be held with management on the procedures (controls) in place to detect or prevent fraud.
iii. The risks of possible fraud should be identified and its possible impact on the financial statements should be evaluated.
iv. Audit procedures should be designed to obtain evidence that fraud, which may impair the financial statements, has not occurred, or has been detected and corrected (or disclosed in the financial statements).

3.2.4 Risk assessment procedures

Both ISA 240 and 315 require discussion among engagement team members on how and where the financial statements may be susceptible to fraud**.**
Risk assessment procedures to obtain information in identifying the risks of material misstatement due to fraud shall include:
Enquiries of management regarding:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud;
- Management's process for identifying and responding to the risks of fraud in the entity;
- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud ;
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour; and
- knowledge of any actual, suspected or alleged fraud affecting the entity.

Obtaining an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control established to mitigate these risks.

Inquiries of those charged with governance for knowledge of any actual, suspected or alleged fraud affecting the entity.
Evaluating whether any unusual relationships have been identified while performing analytical procedures that may indicate risk of material misstatement due to fraud.
Evaluating whether any fraud risk factors are present.
Fraud risk factors include:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud.
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- An ineffective control environment may create an opportunity to commit fraud.

Examples of fraud risk factors
ISA 240/NSA 5 does not attempt to provide a definitive list of risk factors but, in an appendix, identifies and gives examples of two types of fraud that are relevant to auditors:

- ❖ Fraudulent financial reporting, and
- ❖ Misstatements arising from misappropriation of assets

For each of these, the risk factors are classified according to three conditions that are generally present when misstatements due to fraud occur:

- ❖ Incentives/pressures
- ❖ Opportunities
- ❖ Attitudes/rationalizations

Fraudulent financial reporting
Incentives/pressures

- ❖ Financial stability/profitability is threatened by economic, industry or entity operating conditions.
- ❖ Pressure for management to meet the expectations of third parties
- ❖ Personal financial situation of management threatened by the entity's financial performance
- ❖ Excessive pressure on management or operating personnel to meet financial targets.

. *Opportunities*

- ❖ Significant related-party transactions
- ❖ Assets, liabilities, revenues or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to collaborate.
- ❖ Domination of management by a single person or small group without compensating controls.
- ❖ Complex or unstable organisational structure as evidenced by difficulty in determining organizations or individuals that have controlling interest in the entity, high turnover of senior management, legal counsel etc
- ❖ Internal control components are deficient e.g due to inadequate monitoring of controls, ineffective accounting and information systems etc

Attitudes/rationalizations

- ❖ Ineffective communication or enforcement of the entity's values or ethical standards by management
- ❖ Known history of violations of securities laws or other laws and regulations
- ❖ A practice by management of committing to analysts, creditors or other third parties to achieve aggressive or unrealistic forecasts
- ❖ Low morale among senior management

- ❖ Relationship between management and the current or predecessor auditor is strained

Misappropriation of assets

Incentives/pressures,

- Personal financial obligations
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft e.g known or anticipated employee layoffs.

Opportunities,

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Inadequate internal control over assets
- Overriding existing controls
- Failing to correct known internal control deficiencies

Attitudes/rationalizations

- Behaviour indicating displeasure or dissatisfaction with the entity
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft

Note: Above list not exhaustive.

Management override of controls is a strong factor that creates opportunities for fraud.

To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:

- Test the appropriateness of journal entries in the general ledger and other adjustments made in the preparation of the financial statements
- Review accounting estimates for biases that could result in material misstatements due to fraud; and
- Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside the normal course of business for the entity or otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

3.2.5 Written Representation

ISA 240 requires that the auditor obtains written representations from management and those charged with governance that:

- They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud
- They have disclosed to the auditor management's assessment of the risk of fraud in the financial statements.
- They have disclosed to the auditor their knowledge of fraud/suspected fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements.
- They have disclosed to the auditor their knowledge of any allegations of fraud/suspected fraud communicated by employees, former employees, analysts, regulators and others.

3.2.6 Auditor's Communication Responsibility When fraud/irregularity is suspected

1. Any identified fraud or information indicating that fraud may exist should be communicated as soon as practicable to the appropriate level of management.

2. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to parties outside the client entity. But where the relevant anti-fraud Act/regulatory authority mandates that such frauds should be reported to the Regulatory and Enforcement Authorities, the auditor should obtain legal advice(if need be) and act appropriately.

For example, S. 45, FRCN Act, No.6, 2011 stipulates:

i. Where during the course of the audit of an entity, a professional Accountant is satisfied or has reason to believe that a material irregularity has taken or is taking place, he shall without delay –

(c) Notify in writing the CEO of the public entity and all members of the Board of the entity of the irregularity, giving particulars of the irregularity; and

(d) Request every person referred to in (a) above, either individually or collectively to take such action as the professional accountant may deem necessary.

ii. The professional accountant shall within 30 days of the issuance of the notice in sub-section 1, notify the Council of the material irregularity, together with any other relevant information

Note: It is important that the auditor obtains a written representation that management accepts responsibility for the prevention and detection of fraud and that management has made all relevant disclosures to the auditor.

3.2.7 Summary of Auditor's procedures when fraud or error is suspected

The auditor should take the following steps when fraud or error is suspected:

i. Identify the extent and possible impact on the financial statements of the fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatement.

ii. Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision to the original audit plan.

iii. The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments.

iv. The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected.

v. The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a company, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign.

vi. The auditor should consider the impact on his audit report to the shareholders, in terms of any impact on the true and fair view presented by the financial statements.

vii. The auditor should consider whether there is any requirement to report to appropriate authorities. This must be considered in the context of the auditor's duty of confidentiality to his client.

4.0 Conclusion

The users of auditor's services often have expectations regarding the roles, duties and responsibilities of an auditor that far exceed the current practice in the profession and indeed beyond the bounds defined by the statutes, guidelines and standards. This has given rise to the so-called 'audit expectation gap'. In some cases, the expectation of the public may be appropriate, as when the auditor's performance falls below the prescribed standard, but in some other cases inappropriate as when the public expect the auditor to prevent and/or detect fraud. Thus, the issue of fraud is one of the major areas of expectation gap. Thus far, the position of the profession is that management has the responsibility to prevent and/or detect fraud.

5.0 Summary

In this unit, the concept and types of audit expectation gap are explained, as well as guidance given by legislation and the profession to reduce the expectation gap. Also discussed are the concepts of fraudulent financial reporting and misappropriation of assets; the respective responsibilities of the auditor and management in the detection of fraud and the role of professional scepticism in the detection of fraud. The unit went further to identify some fraud risk factors, the auditor's procedures when fraud and error are suspected as well as his communication responsibility in the event of fraud being suspected.

6.0 Tutor-marked assignments

1. **ISA 240** requires that in planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.The overriding requirement of the standard therefore is that an auditor should be aware of the possibility of there being misstatements due to fraud or error and design procedures that will enable him detect such.

Required:

(i) Briefly explain:

a. Fraudulent financial reporting (2 marks)
b. Misappropriation of assets. (2 marks)

(ii) Outline the steps an auditor should take when fraud or error is suspected in the financial statements. (6 marks)

(iii) Explain the role of professional skepticism in the detection and/or prevention of fraud. (5 marks)

(Total 15 Marks)

2. Users of audit services have expectations regarding the roles, duties and responsibilities of an auditor that far exceed the current practice in the profession and indeed beyond the bounds defined by the statutes, guidelines and standards.

Required:

a. Briefly explain: (i) Communication gap; and (ii) Performance gap. (4 marks)

b. Discuss any **four** areas of auditor's duties where different user groups have different expectations.

(8 marks)

c. State any **three** controls put in place by the professional accountancy bodies and the statutes to reduce audit expectation gap. (3 marks)

(Total 15 Marks)

7.0 References/further reading

1. Financial Reporting Council of Nigeria, Act no.6, 2011
2. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST
3. Hayes, R et al(2005), Principles of Auditing: An introduction to international standards on auditing. England: Prentice Hall (Pearson Education Publishers).
4. International Standards on Auditing 200, 240 and 315.
5. Investments and Securities Act 2007.

Unit 6: PRACTICE MANAGEMENT PART I (Quality Control: ISA 220 and ISQC 1)

Content

1.0 Introduction

The output of any audit engagement is largely dependent on the firm-wide quality control system in existence and the application of this system to the individual audit engagement. In this unit, we examine the requirements of ISQC 1*Quality Control for Firms that perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements* and ISA 240,*Quality Control for an Audit Of Financial Statements).*

2.0 Objectives

By the end of this unit, you should be able to:

- Discuss the elements of quality control
- Describe the need for and role of the quality control reviewer
- Explain the different types of peer review.

3.0 Main Content

3.1 The need for a quality control system in accountancy firms

It is important that auditors should perform their professional work with due skill and care and with a proper degree of technical competence. Audit work may be performed by members of a large team of auditors (the 'engagement team') with different levels of knowledge and experience. This makes it necessary that audit firms have a strong system of quality control which provides guidance to engagement team members.

Quality audit work reduces legal action by the client for negligence and also helps the firm/auditor avoid:

- legal damages and legal costs
- the loss of the client
- adverse publicity and damage to the reputation of the audit firm and the profession as a whole
- disciplinary proceedings by a professional body such as ICAN

3.1.1 Quality Control Procedures

Quality control procedures can be considered at two levels:

- the audit firm as a whole
- each individual audit engagement.

A. Quality control at audit firm level: ISQC 1

ISQC 1/NSQC 1 – *Quality Control for Firms that perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements.* This deals with a firm's responsibilities for its system of quality control for audits and reviews of financial statements, and other assurance and related services engagements.

Elements of a firm's System of Quality control

ISQC 1/NSQC 1 requires that a "firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances."

The elements to be addressed in a firm's system of quality control are:

1. leadership responsibilities for quality within the firm;
2. ethical requirements;
3. acceptance and continuance of client relationships;
4. human resources/assignment of engagement teams;
5. engagement performance; and
6. monitoring (internal and external)
7. Documentation

1. Leadership

Leadership sets the 'tone at the top' that will convey strong support for quality work and quality control culture. Thus, the standard requires that a firm establishes policies and procedures designed to promote an internal culture based on recognition that quality is essential in performing engagements. The managing partner of firm's managing board of partners is required to assume ultimate responsibility for the firm's system of quality control and ensures that any persons assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability, and the necessary authority to assume that responsibility.

Leadership therefore, involves:

- setting the strategies and objectives – aligning personal and business objectives of partners, staff and business units with the need for audit quality;
- balancing commercial and professional approaches – the leadership needs to be sufficiently experienced to understand where there may be threats to audit quality, either through pressure from client management or internal efficiency targets;
- ensuring the organization will deliver the required quality;
- ensuring quality is always communicated.

2. Ethical requirements

ISQC 1 requires the firm to establish policies and procedures to provide it with reasonable assurance that the firm and its staff:

- comply with relevant ethical requirements, and
- maintain independence where required to do so by those requirements.

The firm should:

- communicate its independence requirements to staff, and
- identify and evaluate circumstances and relationships that create threats to independence, assessing the impact of such threats and applying safeguards or withdrawing from the engagement if appropriate.

The policies and procedures should include requiring:

- staff to notify the firm of circumstances and relationships that might create a threat to independence
- staff to notify the firm of any breaches of independence of which they have become aware
- the firm to communicate such breaches to the engagement partner and other relevant staff
- the engagement partner to advise the firm of action to be taken.

At least annually, the firm should obtain written confirmation from all staff of compliance with the firm's policies and procedures on independence.

3. Acceptance and continuance of engagements

ISQC 1 requires the firm to establish policies and procedures to provide it with reasonable assurance that the firm will only take on or continue work where the firm:

- is competent to perform the engagement
- has the capabilities (including the necessary resources and time) to do so
- can comply with the relevant ethical requirements, and
- has assurance of the client's integrity (that is, does not have information which would lead it to conclude that the client lacks integrity).

The policies and procedures should include requiring the firm to:

- obtain sufficient information to make such decisions (for new or existing engagements)
- consider potential conflicts of interest (and therefore whether it should accept the engagement)

- document all identified issues and how they were resolved.

When an audit firm accepts an audit engagement from a new client, suitable procedures should be carried out to ensure that:

- the firm will be independent and there are no conflicts of interest
- the firm has the technical competence to do the work
- professional clearance has been obtained from the previous auditors of the new client
- appropriate anti-money laundering (client identification) procedures are performed.

Before the start of the audit each year, the engagement partner for the audit should ensure that all members of the audit team are independent of the client and there are no conflicts of interest; and be satisfied with the ethical integrity of the client entity and its management.

Client relationships are managed at two levels namely:

- Managing overall client base by accepting and continuing to act only for those audit clients where a quality service can be delivered, considering integrity of the principal owners, key management and those charged with governance of the entity; and

- Managing client relationships appropriately on a day-to-day basis so that an efficient audit is undertaken while achieving audit quality with an appropriate level of financial return.

Note:*An evaluation of prospective clients and a review on an ongoing basis, of existing clients should be conducted. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. The auditor should be courageous to withdraw from any relationship that threatens or tends to compromise quality regardless of the level of financial return.*

Note: Where it becomes appropriate to withdraw from an engagement, it is necessary to

1. discuss with the appropriate level of client's management and those charged with its governance, the decision to withdraw from the engagement or from both the engagement and the client relationship and the reasons for the withdrawal.
2. consider whether there is a professional, regulatory or legal requirement to report the withdrawal to regulatory authorities.
3. document significant issues, consultations, conclusions and basis for the conclusions.

Client's Integrity

Matters concerning client's integrity to be considered for the purpose of acceptance or continuance of client relationships include:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the clients operations, including its business practices.

- Information concerning the attitude of client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of the work.
- Indications of client's involvement in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-appointment of the previous firm.

4. Human Resources/Assignment of Engagement Teams

The quality of any audit is as good as the people that undertook the engagement. Meeting the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior centre around people who:

- are intelligent, discerning and ethical;
- genuinely believe in the public interest purpose of audit;
- are curious and enquiring by nature with strong inter-personal skills;
- have sufficient strength of character to stand firm in challenging or confrontational situations;
- have up-to-date technical knowledge and understanding of their clients' business;
- are motivated, both personally and by their working environment, to deliver quality efficiently and to the best of their abilities.

The standard therefore requires a firm to ensure:

- it has sufficient personnel with the competence, capabilities and commitment to ethical principles to meet its overall quality control objectives, and
- that for each engagement an appropriate engagement partner and team are assigned.
- Personnel have an understanding of the firm's quality control policies and procedures.

Policies should therefore exist for the recruitment, training and development of staff. The firm should ensure compliance with ISAs and audit staff should have a good knowledge of accounting standards and local/national statutory accounting regulations.

The firm's technical auditing procedures should be set out in a manual and reinforced by training. Newsletters and/or meetings could be used as a means of ensuring that professional staff are kept up-to-date on current developments.

Work should be assigned to staff that are competent to perform that work. There should be procedures for ensuring that an audit team collectively has the appropriate level of technical knowledge for the audit engagement and includes individuals with experience of audits of a similar complexity, and an ability to apply professional judgment.

5. **Engagement Performance**

Achieving audit quality requires embedding good working practices in the audit process. Good working practices encompass:

- ensuring each member clearly understands his role and responsibilities and using coaching effectively;

- instilling an attitude of professional skepticism and communicating important audit issues within the team timely;

- applying original thought to planning and execution of an audit in order to tailor the approach to the client's particular circumstances;

- performing review procedures and the completion of audits in an effective way so that all issues are addressed appropriately and time pressure is dealt with robustly;

- ensuring that there are appropriate resources for consultation, and fostering a culture whereby seeking consultation is seen as a strength, not a weakness, (Igbokwe 2010).

The firm, through its policies should seek to establish consistency in the quality of engagement performance. This is achieved through documentation and communication of firm's processes/methods:

- for complying with engagement standards;
- of engagement supervision, staff training and coaching;
- reviewing the work performed (including timing and extent of the review), the significant judgments made and the form of report being issued;
- of consultation with individuals, within and outside the firm, who have specialized expertise, to resolve difficult and contentious matters.

Note: 1. There should be policies and procedures in place on how to resolve differences in opinion arising from consultations.

2. A firm should also establish policies and procedures requiring an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. The engagement quality review (internal or external) will need to be completed before the report is issued.

6. Monitoring

The Standards require that the firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Monitoring compliance with quality control policies and procedures aims at providing an evaluation of:

- adherence to professional standards and regulatory and legal requirements;
- whether the quality control system has been appropriately designed and implemented; and

- whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Monitoring of compliance could be external or internal.

Internal monitoring
Internal assessment is critical to ensuring an effective quality assurance and improvement programme.

- Quality processes should be designed to assist the leadership and practice management in improving and refining audit quality, managing risk and improving both inputs and outputs.

- Quality processes should recognize the key ingredient of people; especially quality of individual judgments and the development of individuals.

- Quality processes themselves can usually be improved as the results of lessons learnt. Members of staff are more likely to be cooperative if they consider that the reviewers themselves are constantly re-appraising, and where necessary modifying their own procedures.

External monitoring
This relates to "external audit" performed by the regulatory and professional bodies e.g. Professional Practice Monitoring Committee (PPMC) of ICAN and FRC. The regulatory visit is an important indicator to firms as to whether their quality control processes meet the standards required. Quality processes need to work in harmony with the checks and balances within working practices such as independent reviews and hot reviews, and also external monitoring of the regulatory bodies.

Note: 1. An independent external inspection program does not act as a substitute for firm's own internal monitoring programme.
2. Deficiencies noted during monitoring should be communicated to both engagement partners and personnel and the firm for implementation of recommended remedial actions – changes to policies, improvement in training and professional development, disciplinary action for infraction of policies etc.
3. Genuine complaints and allegations of non-compliance with the firm's system of quality control or that work performed fails to comply with professional standards, regulatory and legal requirements, should be promptly addressed.

7. Documentation

A firm should document evidence of the operation of the each element of its system of quality control. Factors to consider when determining the form and content of this documentation include:

- The size of the firm and number of offices;
- The degree of authority both personnel and offices have; and
- The nature and complexity of the firm's practice and organization.

Self-assessment question
1. Briefly explain the elements of the quality control system of a professional accounting firm.

B. Quality Control on an Individual Audit (ISA 220 - *Quality Control for an Audit of Financial Statements*

This standard applies the principles of ISQC 1 to an individual audit. It requires firms to apply quality control procedures over individual audit engagements.

Objective (ISA 220.6)
The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report issued is appropriate in the circumstances.

Leadership responsibilities for quality on audits
The engagement partner sets the tone. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Ethical Requirements

The engagement partner has to ensure, through observations and enquiries that all engagement team members comply with ethical requirements as contained in IFAC/ICAN Code for members.

ISA 220.11 and 220.24 give guidance about independence:

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

(d) The auditor shall include in the audit documentation conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

Acceptance/continuance of client relationships and specific audit engagements

The engagement partner must ensure that the requirements ISQC1 with regard to acceptance and continuing with an audit engagement are continually met. Any information obtained that would have caused the partner/firm to decline the audit in the first place should be communicated to the firm for quick action to be taken. The engagement partner must document conclusions reached about accepting and continuing an audit.

Assignment of engagement teams
It is the responsibility of the engagement partner to ensure that the team is appropriately qualified and experienced as a unit for a particular engagement.

Engagement Performance
The engagement partner has the responsibility of ensuring good engagement performance. This involves such issues as direction, supervision, consultation, resolution of disputes and differences of opinion and review.

Direction: The engagement partner holds a meeting with team to discuss the audit and its associated risks. Thus 'direction' includes informing engagement team members of:
- Their responsibilities
- The objectives of the work to be performed
- The nature of the client's business
- Risk-related issues and other problems that may arise and
- The detailed approach to the audit assignment.

Supervision: The partner has the overall supervisory responsibility but practical supervision is given by line officers – seniors to juniors. Matters of attention will include:
- Tracking the progress of work
- Considering the capabilities and competences of the team members and their peculiar challenges
- Addressing significant issues that arise in the course of the work and modifying the planned approach if need be
- Identifying matters for consultation with more experienced team members.

Consultation/resolution of disputes: The engagement partner ensures that consultations are made for contentious or difficult matters that may arise during the audit and that such matter and conclusions reached are properly documented.

Where the differences of opinion arise, he should ensure their resolution in line with the firm's policy for such differences of opinion.

Review: A review consists of consideration whether, for example:
- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved

Quality Control Review

The engagement partner may appoint a quality control reviewer with sufficient technical expertise, if necessary. Such review must be completed before the audit report is signed.

Quality control reviews usually include selective review of working papers relating to significant judgments made, review of financial statements, other matters, the report and consideration of whether the report is appropriate.

Generally, the review for a listed company will include:

- Discussion of significant matters with the engagement partner;
- Review of financial statements and the proposed report;
- Evaluation of the firm's independence in relation to the specific engagement
- Significant risks identified during the audit and the responses to those risks
- Judgments made with respect to materiality and significant risks
- Any consultations on matters involving differences of opinion, or other difficult or contentious matters and conclusions arising from those consultations
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement
- The matters to be communicated to management and those charged with governance, and where applicable other parties such as regulatory agencies.
- Evaluation of the conclusions reached in formulating the auditor's report.
- The appropriateness of the report to be issued.

Note:

- The quality control reviewer documents his work confirming that the firm's requirements for a review have been met, that the review was completed before the audit report was issued and that he is not aware of any unresolved issues.
- A peer review is a review carried out by another partner in the assurance firm. A peer review can take the form of a HOT review (review carried out before the audit report is signed or a cold review (review carried out after the audit report is signed).

Monitoring

The engagement partner needs to always keep in view the results of the monitoring of his firm's or network firms' quality control systems and consider whether they have any impact on the specific audit he is conducting.

3.1.2 Summary of Quality Control Arrangements for Individual Audits (ISA 220)

The engagement partner has responsibility for the overall quality of the audit and is required to put procedures in place to ensure that ethical standards are complied with and appropriate action taken if there is evidence to the contrary as well as ensure that independence requirements are met. In this regard, he has to put policies in place for:

- identifying circumstances and relationships that might give rise to threats to independence

- assessing the impact of breaches of the firm's independence policies and procedures and whether such breaches create a threat to independence
- taking suitable action to eliminate identified threats or to withdraw from the engagement if appropriate

Other quality control responsibilities of the engagement Partner include ensuring that:

- procedures are in place to deal with the acceptance of new engagements and the continuance of existing engagements
- the audit is carried out by an audit team with the appropriate competence and capabilities
- appropriate management of the engagement is in place, including the direction and supervision of staff and the review of audit work. On or before the date of the audit report the engagement partner must, through a review of audit documentation and discussion with the audit team be satisfied that sufficient, appropriate evidence has been obtained to support the conclusions reached.
- adequate consultation has taken place on difficult or contentious matters and the conclusions from such consultation implemented
- an appropriate monitoring system is in place
- the following matters are documented:
    - issues in respect of compliance with ethical requirements and how they were resolved
    - conclusions on compliance with independence requirements
    - conclusions in respect of new and continuing engagements
    - the nature and scope of conclusions from consultations undertaken.

For audits of listed companies, and any other audits where the firm has determined that an engagement quality control review is required, the engagement partner is also required to appoint an engagement quality control reviewer, who:

- performs an objective evaluation of the significant judgments made by the audit team and the conclusions reached, including:
    - discussion of significant matters with the engagement partner
    - review of the financial statements and the proposed audit report
    - review of selected audit documentation relating to significant judgments
    - an evaluation of the conclusions reached and whether the proposed audit report is appropriate
- considers the engagement team's evaluation of the firm's independence in relation to the audit engagement
- considers whether appropriate consultation has taken place on difficult or contentious matters
- considers whether audit documentation selected for review reflects the work performed and the conclusions reached.

3.2 Review of Audit Work

A very important aspect of any quality control system is the review of audit work. Ideally, an auditor with a higher level of competence and experience than the audit team members who performed the audit work should conduct the review. The review process may take any of the following forms:

Peer review: This is a review carried out by another partner in the assurance firm.

Engagement quality control review (EQCR): A peer review performed before the audit report is signed as required by ISQC1 during the audit of a listed or public interest entity. An EQCR forms part of the quality control procedures specific to an individual assignment.

Hot review: Also review carried out before the audit report is signed. It is similar in substance to an EQCR except that the hot review is not performed as a direct requirement of ISQC1. For example, it may be done when an engagement partner wants a second opinion or to monitor the work of a new partner during probation.

For individual engagements, it is also a review of working papers done by a more senior member of staff during the course of the audit. It is performed soon after the work is completed. The review ensures that the work has been performed in line with the audit programme and that the conclusions are consistent with the results obtained.

Monitoring review (also called a 'cold review'): This is a peer review performed after the audit report is signed. A cold review forms part of the monitoring of quality control procedures.

A cold review at individual engagement level is performed at the end of the audit by the audit manager or engagement partner. It involves a review of the whole file together with the financial statements, to ensure that the work has been fully completed and that the results and conclusions for the entire audit are consistent. The manager or part conducts this review before the audit report is signed off.

The purpose of audit review is to check whether:

i. the audit work was carried out to proper professional standards
ii. the objectives of the audit have been achieved
iii. the work carried out during the audit and the audit evidence are suitably documented, and that the audit evidence supports the conclusions that have been reached.

The review of the audit work should cover the audit planning process and audit procedures, including:

- documentation (the audit working papers)
- the audit tests performed and the audit evidence gathered
- compliance with the audit work programme
- the resolution of problems encountered on the audit

- whether the conclusion reached is consistent with the audit evidence obtained and documented.

It is important that the review process itself should is documented.

4.0 Conclusion

The quality of the audit work and report determines the level of reliance users of the auditor's services will place on his work and lends a lot of credibility to the financial statements. This makes it imperative that firms should maintain good quality control system that will ensure good quality work which ultimately enhances their reputation, the image of their profession and helps avoid litigation cases for negligence.

5.0 Summary

This unit discussed quality control system at firm level as stipulated in ISQC 1 and the application of the elements of the quality control system to individual audit engagements in line with ISA 220. The role of the quality control reviewer ensuring quality control is highlighted as well as the importance of peer review as a form of quality assurance in performance of audit engagements.

6.0 Tutor- marked Assignment

1. a. Discuss the following **FIVE** elements of good quality control in a firm of Chartered Accountants:

i. Independence (2 Marks)
ii. Personnel management (2 Marks)
iii. Acceptance of and continuance with client (2 Marks)
iv. Engagement performance (2 Marks)
v. Monitoring (2 Marks)

b. As the Audit Manager in charge of Silver Limited's audit for the year ended 31 December, 2014, state and explain **FOUR** quality control procedures you will apply for the effective management of the audit. (10 Marks)

(Total 20 Marks)

(ICAN May 2016)

2. ISA 220 *Quality Control for An Audit of Financial Statements* states that the objective of the auditor is to implement quality control procedures at theengagement level that provide the auditor with reasonable assurance that the audit complies with professional standards and applicable legaland regulatory requirements and the auditor's report issued is appropriate in the circumstances.

Required:

Discuss, within the context of ISA 220, the responsibilities of the engagement partner with regard to ensuring:

a. Adherence to Ethical requirements/independence (5 marks)

b. Good engagement performance. (10 marks)

(Total: 15 marks)

7.0 References/further reading

1. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International

2. International Standards on Auditing 220; International Standard on Quality Control (ISQC) 1.

3.Igbokwe, K. (2010). Audit quality assurance: A global perspective. A paper delivered at the 40th Annual Accountants' Conference of The Institute of Chartered Accountants of Nigeria, held between October 11 – 15, 2010 at International Conference Centre and Sheraton Hotel & Towers, Abuja.

UNIT 7: PRACTICE MANAGEMENT PART II

Content

1.0 Introduction

This unit explores further the requirements of professional practice management. In it we shall discuss the professional and ethical rules/guidelines in accepting nomination as a new auditor in place of the existing auditor, tendering for jobs as well as defining and agreeing the terms of the service contract between the auditor and his client.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain why companies change existing auditors
- Outline the procedures an auditor should follow when nominated as a new auditor of a company
- Explain the process of tendering for a new audit work
- Discuss the ethical rules to observe when advertising the auditor's services
- Demonstrate your understanding of the provisions of ISA 210 *Agreeing the terms of audit engagement*

3.0 Main Content

3.1 Changes in a Professional Appointment

3.1.1 Change of an Existing Auditor

Section 362, Companies and Allied matters Act, Cap C20, LFN 2004 provides for the removal of an auditor before the expiration of his term of office, while S.365 allows for the resignation of an auditor before his term expires. Also, an old auditor may not be re-appointed after his tenure for any of several reasons.

When any of these events happens, an auditor may be approached to take up a new appointment as an auditor a company.

A change of an auditor may arise for many reasons including:

i. The company has grown bigger in size and level of activities and the current firm is too small to cope with the demands of the expanding client.
ii. There may be a change in the composition of the company's board of directors, and the new directors wish to accommodate their interest.
iii. There may be a perceived lack of independence, possibly one that has just arisen.
iv. A disagreement between the directors and the 'old' audit firm and/or
v. a loss of confidence in the 'old' audit firm.

3.1.2 Procedures before Accepting a new Audit Appointment

Before accepting a new audit client, the auditor should ensure that there are no independence or other ethical problems that could militate against the engagement. New auditors should ensure that they have been validly appointed.

The nominee auditors should carry out the following pre-acceptance procedures:

i. The auditors should ensure they are professionally qualified to act as auditors and that there are no legal or ethical grounds that could disqualify them.

ii. The auditors should ensure that existing resources in terms of available time, staff and technical expertise are adequate.

iii. The auditors should screen the prospective client i.e. make independent enquiries about the credibility of the directors if not personally known to the auditors.

iv. Communicate with existing auditors to enquire if there are professional and ethical reasons that could prevent them from accepting the client (referred to *as professional enquiry*).

Client Identification

The audit firm should carry out client identification procedures in line with anti-money laundering regulations. These procedures confirm credibility of the client and that there are no reasons to suspect that the client may be involved in money laundering activities. Evidences sought may include documentary evidence of the identity of the entity such as certificate of incorporation in the case of a company or Business registration certificate and confirmation of the address of the entity, through headed letter paper or Utility bills. If the client is an individual, evidence of identity can be obtained from a passport or driving licence, and evidence of address (possibly) from a recent utility bill. The audit firm should consider whether the business of the potential new client 'makes commercial sense'. The size of the company should align with the nature of its business operations.

Professional Enquiry

The nominee firm should communicate with the existing or outgoing auditors to determine if there are any professional and/or ethical reasons why the audit may not be accepted. Such communication will involve discussion of the appointment, the client and the audit work.

The following communication process should be followed:

i. Upon nomination, the prospective auditor should inform the prospective client that he has a professional duty to communicate with the existing auditor.
ii. If the prospective client refuses to give its permission, the appointment as auditor should not be accepted.
iii. If the client does not give the current auditor permission to reply to any relevant questions, the current auditor should inform the prospective auditor who should reject appointment.
iv. If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.
v. The existing auditor or adviser should answer without delay the communication from the prospective auditor, whether or not there are matters of which the prospective auditor should be aware.
vi. Where the existing auditor or adviser prefersoral communication of the facts to the prospective auditor, each party should make his own record of such a discussion.
vii. The prospective successor auditor should discuss any conflicting viewpoints raised by the outgoing auditor with the client and satisfy himself either that the client's view is one which he can accept as reasonable or that the client will accept that the incoming auditor or adviser might have to express a contrary opinion.
viii. Where the existing auditor or adviser does not respond within a reasonable time, the prospective successor should endeavour to contact the existing auditor by some other means, for instance, by telephone, facsimile or email.
ix. where this fails, and the prospective successor has no reason to believe that the change of auditor is being legally and properly effected , he should send a final letter by recorded delivery service stating that unless he receives a reply within a specified time he will assume that there are no matters of which the existing auditor is aware that should be brought to his attention.
x. If the prospective auditor is satisfied that he can properly act, and is prepared to accept nomination/appointment, he should so inform the client in writing.

Procedures after accepting nomination

After client screening (check on the risk level of the client and integrity of management), the audit firm should carry out the following procedures:

i. Ensure that the outgoing auditor's removal or resignation has been properly conducted in accordance with legislation (law of the land) and that all outstanding fees due to the other member have been fully paid. Sight the resignation letter or confirm proper removal of the outgoing auditor.
ii. Ensure that your (the new auditor's) appointment is valid. Obtain a copy of the resolution passed at the AGM appointing you as auditor.

iii. Write and submit a letter of engagement to the directors of the company.
iv. Obtain from the old auditors, all books and papers which belong to the client, unless the old auditors have a particular lien over the documents for unpaid fees.

3.1.3 Obtaining and charging for Professional work

Audit firms increase their client base through promoting their reputation in the business community, recommendations from existing clients as well as advertising, publicity and promotion.

Advertising and publicity

Advertising and publicity activities by accountancy firms are regulated by IFAC and ICAN through their codes of ethics and conduct respectively.

The main requirements for marketing professional services are that the advertising and publicity material used by any firm:

a. must not bring into disrepute the professional body, the firm or the profession as a whole
b. should not make exaggerated claims for services offered, qualifications possessed or experience gained
c. must not discredit the services provided by other firms or make disparaging references to unsubstantiated comparisons to the work of another Chartered Accountant
d. It should be honest and truthful and not mislead, either directly or by implication
e. must not break any locally recognised codes of advertising practice, in terms of its legality, decency, honesty and truthfulness.

Note: Students should recall the requirements of one of the fundamental ethical principles, i.e. PROFESSIONAL BEHAVIOUR.

Reference to fees in advertising and publicity is not encouraged. If fees are mentioned, there should be a statement of the basis on which the fees are to be charged. Comments about fees:

- must not be misleading
- must not offer discounts, and
- must not make comparison with the fees of other service providers.

Fees and Remuneration

Section 361 of CAMA provides that, in the case of auditors appointed by the directors, their remuneration may be fixed by the directors; or the remuneration may be fixed by the company in a general meeting or in such manner as the company in general meeting may determine. Remuneration here includes fees and expenses.

However, ICAN Code of Conduct provides guide to members on charging for services provided.

Where the basis of a fee has not specifically been agreed, then a member should charge a fee which is fair and reasonable taking into account:

- the seniority and professional expertise of the persons necessarily engaged in the work;
- the time expended by each;
- the degree of risk and responsibility which the work entails;

- the priority and importance of the work to the client together with any expenses properly incurred.

Fees charged to clients should be in line with quoted and agreed amounts or the tender price. Variations may only apply when extra work outside the agreed scope arises and this should be mutually agreed upon.

Other ICAN code of conduct guidelines

Further specific guidance by the ICAN Code regarding fees as include:

- Minimum charge-out rates in respect of fees for professional services below which members are not ordinarily expected to charge
- A member should inform a client in writing prior to commencement of any engagement the basis upon which any fee he proposes to charge for his services will be calculated.
- Firms should not quote a level of fees for new audit work which is lower than that charged by an existing auditor. Firms should also not quote by tender a level of fees which they have reason to believe is significantly lower than those quoted by other tendering firms.
- When performing audit work firms should ensure that their work complies with auditing standards and guidelines and, in particular, quality control procedures. Quality of services rendered should not be compromised on the basis of low fees.
- A member whose fees have not been paid may be entitled to exercise a lien on certain books and papers of a client upon which he has been working and may refuse to pass on information to the client or his successor Chartered Accountant, until those fees are paid. The incoming auditor has a duty to assist in the recovery of such fees within a reasonable time.
- Fees should generally not be based on a percentage or on contingency calculations for audit work, reporting assignments and similar non-audit roles.

Self-assessment question

1. Outline the procedures a nominee auditor should adopt before accepting appointment as an auditor of a company.
2. Explain the requirements of the profession with regard to advertising and charging for professional job.

3.2 Tendering

Tendering is a process of responding to an invitation to quote for a new audit work. It may involve two or more audit firms which may or may not include the existing auditor.

3.2.1 Initial considerations

A firm should not submit a tender for a prospective work unless it is convinced that:

i. It has the expertise to carry out the audit.
ii. it has or could source sufficient staff at the appropriate time to handle the work.

iii. there are no ethical reasons why the firm could not act (for example, a problem with independence, or a conflict of interest).
iv. there are no problems, of which the firm is aware, with the current audit or auditors.

The auditor should consider what audit risks might arise with the particular client prospecting for a new auditor.

3.2.2 The tendering process

The tendering process should be broken down into the following stages (assuming that a firm is submitting a tender for the audit of a new client):

a. Collection of background information about the possible new client. This helps in determining whether the fee is to be set by tender or by any other method.
b. Establish the precise scope of the work to be performed and the specific requirements of the prospective client.
c. Carry out a preliminary audit risk assessment and prepare a preliminary plan for the audit. The plan must cover the staffing requirements and the time requirements for the work.
d. Based on a. - c. above, estimate a fee.
e. Prepare a submission document for the potential client. The contents of this document usually include:
    - an outline of the key characteristics of the firm
    - clarification of the nature of the audit work or other non-audit work to be performed
    - a statement of the requirements of the client and how the firm will comply with them
    - an outline of how the work will be performed (method statement)
    - the proposed fee and the basis of its calculation
    - the range of other services which the firm could offer to the client.
    - reference projects/engagements the firm has undertaken in the past.
f. If required, prepare and give a presentation to the potential client.

Note: Tenders are usually prepared in two parts, namely, technical proposal and commercial proposal. The technical proposal deals with matters highlighted in e. above while the commercial proposal deals with item d. above.

3.2.3 Evaluating the tender

In evaluating the tender, the client (company) is likely to consider the following issues:

i. Fees
ii. The services that the firm is able to provide
iii. Geographical locations and coverage of the firm's offices
iv. Expertise of the firm and its staff; reference projects they have done will be evaluated.
v. Reputation of the firm
vi. Whether the senior management of the company think that they will be able to work well (on a personal level) with the potential engagement partner and key audit staff

vii. The formal presentation itself by the audit firm

viii. The extent to which the company wants to change its audit firm, and its dissatisfaction with the current audit firm.

Knowledge of these evaluation criteria should guide the audit firm in packaging any tender.

3.2.4 Lowballing

Lowballing, as earlier noted in this course, is a practice of charging less than the market rate for an audit when tendering for new clients. When a firm quotes a significantly lower fee level for an audit service than would have been charged by the predecessor firm or other competing firms, it may tend to cast some doubt on the reputation of the firm and the quality of the audit work.

However, a firm may use lowballing as a penetration pricing strategy, hoping that it will be able to raise the audit fee in future years, or it will be able to recover losses on the audit fee by providing other, more lucrative non-audit services. All fees should be sufficiently adequate to compensate a firm for the work that it carries out.

3.2.5 Credit control within an audit firm

An audit firm should have policies in place to collect fees promptly from clients. A failure to invoice clients promptly or a failure to collect payment within a reasonable time after the invoice date would indicate poor credit management.

Occasionally, non-payment of fees may be due to the fact that the audit client is in financial difficulties and cannot pay. Over-due fees are a threat to the independence and objectivity of the auditor. If the unpaid amount has been overdue for a long time, it could be regarded as a form of loan by the audit firm to the client. The risk to auditor independence could be significant if the unpaid amount is material.

When a client is in temporary financial difficulties it is permissible for an auditor to make commercial arrangements for instalmental payments of the fees due.

When unpaid fees are owed by a client, and the period of late payment is in excess of what might be regarded as commercially acceptable, the audit firm should consider whether it would be ethically appropriate to resign as auditors.

Self-assessment question

1. Describe the tendering process when invited to bid for a new assignment.

3.3 Agreeing the terms of an Engagement

ISA 210 *Agreeing the terms of audit engagements* requires that the auditor accepts a new engagement or continues an existing audit engagement if it is established that the preconditions for an audit are present.

The preconditions for an audit are:

- The use by management of an acceptable financial reporting framework in the preparation of the financial statements; and
- The agreement of management and those charged with governance to the premise on which an audit is conducted.

To determine whether the preconditions for an audit are present, the auditor does the following:

- Determine whether the financial reporting framework is acceptable. Consider the nature of the entity, the purpose of the financial statements and whether regulation prescribes the applicable financial reporting framework.
- Obtain management's agreement that it acknowledges and understands its responsibilities for:
  - Preparing the financial statements (FSs) in accordance with applicable reporting framework
  - Internal control that is necessary to enable the preparation of FSs which are free form material misstatements.
  - Providing the auditor unrestricted access to all information and staff for the purpose of obtaining audit evidence.

Where these preconditions are not present, the auditor shall not accept the audit engagement.
The auditor therefore, is required to refuse the engagement where a limitation on scope is imposed by management such that he auditor would be unable to express an opinion on the financial statements, or the financial reporting framework to be used in the preparation of the financial statements is unacceptable, or management do not agree to the above responsibilities.

3.3.1 Audit Engagement Letter

An audit engagement letter is a contract document which defines the terms and scope of the audit engagement. It is usually written by the auditor and sent to the client for confirmation and accent. The reasons/rationale for this letter include to:

- describe clearly the respective responsibilities of management and the auditor;
- to avoid misunderstanding that may arise between the auditor and the client regarding the terms of the engagement;
- to explain and educate the client on the scope of the audit;
- confirm in writing the auditor's acceptance of the engagement;
- reduce the client's expectation gap; and
- spell out the basis for charging audit fees.

3.3.2 Form and contents of an Engagement Letter

The form and contents of an engagement letter may vary for each client but would usually include reference to:

- the objective of the audit of financial statements;
- management's responsibility for the financial statements;
- the responsibilities of the auditor;
- the financial reporting framework adopted by management in preparing and presenting the financial statements;
- the scope of the audit, including reference to applicable legislations, regulations or pronouncements of professional bodies to which the auditor adheres;
- the form of the reports or other communication of the results of the engagement;

- the fact that, due to the test nature and other inherent limitations of an audit, including the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered;
- the auditor's right of unrestricted access to whatever records, documents and other information requested by the auditor in connection with the audit.

The auditor may also want to include:

- regulations, ISAs and other ethical pronouncements;
- arrangements regarding the planning and performance of the audit, including the composition of the audit team;
- expectation of receiving from management written confirmation concerning representations made in connection with the audit;
- request for the client to confirm the terms of the engagement by acknowledging the receipt of the engagement letter, that is, by signing and returning to the auditor a copy of the engagement letter.
- Involvement of other auditors and experts
- Involvement of internal auditors and other staff
- Any restrictions of auditor's liability
- Arrangements to be made with predecessor auditor.
- Description of any other letters or reports the auditor expects to issue to the client; and basis on which fees are computed and any billing arrangements.

Benched marked against international best practice, the engagement letter should include an explanation of the auditor's responsibility with regard to anti-money laundering checks and procedures.

3.3.3 Annual review of the engagement letter

The initial engagement letter may contain provisions for future revision of the terms of engagement based on changing circumstances.

The ISA 210 suggests that the following factors may indicate the need to revise the terms of an engagement:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements, and
- A change in other reporting requirements.

4.0 Conclusion

When nominated to replace an existing auditor, the nominee auditor should ensure he possesses the skill and competence as well as the resources to undertake the assignment. He needs to also ensure that the outgoing auditor is validly removed. Thereafter, he should conduct client screening and conduct professional enquiry to convince himself that there are no ethical and professional reasons for not accepting the nomination. An auditor can also increase his client base through responding to invitation to tender for new jobs or through advertising and publicity. In this regard, he is expected to adhere to ethical and professional rules governing advertising. Finally, when jobs are secured, it is required that the terms of the contract should be made clear through a letter of engagement.

5.0 Summary

This unit discussed the procedures an auditor should adopt before accepting nomination as a new auditor and his procedures after nomination. The process of professional inquiry is equally outlined. The unit also discussed the process of obtaining and charging for professional assignments. This unit also dealt with the tendering process and the need for and contents of an engagement letter.

6.0 Tutor-marked assignment

1. You are a manager in the audit department of Anyasor & Co, Chartered Accountants. A new junior auditor, Joe Ekenze, has asked you to answer some questions which relate to issues encountered in his first weeks of working at Anyasor & Co. The questions are:

i. I know that Anyasor & co is facing competition form a new audit firm, and our firm is advertising its services in a national newspaper. What are the rules on advertising for new clients?

ii. I heard one of the audit managers say that our firm had lost an audit client to a competitor because of lowballing. What is lowballing and is it allowed?

Required:

For each of the questions raised, provide a response to the audit junior, in which you identify and explain the ethical or professional issue raised.

(ACCA adapted)

2. ChuksNwaogwugwu& Co., a firm of chartered Accountants, has recently obtained a new audit client, DICCEE Ltd, whose year end is 31 December. DICCEE Ltd requires its audit to be completed by the end of February; however, this is a very busy time for ChuksNwaogwugwu and so it intends to use more junior staff as they are available. Additionally, in order to save time and cost, ChuksNwaogwugwu has not contacted Diccee's previous auditors.

Required:

a. Describe the steps that ChuksNwaogwugwu & Co. should take in relation to Diccee Ltd:

i. Prior to accepting the audit
ii. To confirm whether the preconditions for the audit are in place

b. State four matters that should be included within an audit engagement letter.

7.0 References/further reading

1. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International

2. Hayes, R et al(2005), Principles of Auditing: An introduction to international standards on auditing. England: Prentice Hall (Pearson Education Publishers).

UNIT 8: AUDIT PLANNING AND CONTROL

Content

1.0 Introduction

In conducting an audit of financial statements, the overall objectives of the auditor, per ISA 200 are:

i. to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to express an opinion on whether the financial statements have been prepared in accordance with the applicable financial reporting framework; and

ii. to report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

ISA 200 states that the key requirements for the auditor to obtain reasonable assurance and to express an opinion are:

- compliance with all ISAs relevant to the audit
- compliance with relevant ethical requirements

- planning and performing an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.
- exercising professional judgment in planning and performing an audit; and
- obtaining sufficient and appropriate audit evidence to allow him to reduce audit risk to an acceptably low level.

2.0 Objectives

By the end of this unit, you should be able to:

- State the requirements of ISA 200 for obtaining reasonable assurance and expressing an opinion on a set of financial statements
- Outline the planning procedure
- Identify and discuss the elements of audit risk
- Describe the auditor's procedures for obtaining an understanding of the entity and its environment
- Distinguish between an audit planning memorandum and the audit plan and explain the benefits of the audit planning memorandum.

3.0 Main Content

3.1 Audit Planning and Strategy – (ISA 300 & NSA 8)

Planning an Audit

ISA 300/NSA 8 states that the objective of the auditor is to plan the audit so that the engagement will be performed in an effective manner. Planning the audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Planning an audit, thus, demands developing both a general strategy and a detailed approach for the expected nature, timing and extent of the audit.

Thus, two documents are referred to by the ISA – the *overall audit strategy* (Audit strategy memorandum) and *the audit plan.*

When establishing the overall audit strategy, the following should be considered:

- Characteristics of the engagement;
- Reporting objectives, timing of the audit and nature of communications;
- Significant factors, preliminary engagement activities and knowledge gained on other engagements; and
- Nature, timing and extent of resources.

The audit plan gives specific procedures to be carried out to implement the strategy and complete the audit.

3.2 PLANNING OBJECTIVES AND PROCEDURE

The objective of planning an audit is to determine the amount and type of evidence and review required to assure the auditor that there are no material misstatements of the financial statements. The planning procedures include:

a. Perform audit procedures to understand the entity and its environment, including its internal control system.
b. Assess the risk of material misstatement of the accounts.
c. Determine materiality. Materiality for planning purposes is the auditor's preliminary estimate of the smallest amount of misstatement that would influence the judgment of a reasonable person relying on the financial statements.
d. Prepare the Planning memorandum, the audit plan and audit program containing the auditor's response to identified risks.

a. **Understanding the entity and its environment (ISA 315)**

ISA 315 requires that the auditor should assess risks of material misstatement through understanding the entity and its environment, including the entity's internal control. This understanding of the environment provides a basis for designing and implementing responses to the assessed risks of material misstatement.

Thus, obtaining an understanding of the entity and its environment enables the auditor to:

- Identify and assess the risks of material misstatements in the financial statements
- Design and perform appropriate audit procedures
- Exercise audit judgment whenever that is required, e.g. when setting audit materiality levels.

In relation to the entity, the auditor would want to gain an understanding of the following:

- The industry, regulatory and other external factors, including the applicable financial reporting framework
- Nature of the entity, including operations, ownership and governance, structure and financing.
- Entity's selection and application of accounting policies, including reasons for changes in accounting policies
- Objectives, strategies and related business risks
- Measurement and review of the entity's financial performance.
- The entity's internal control etc.

To obtain an understanding of the entity and its environment, a combination of the following procedures could be used:

- Inquiries of management, internal auditors and others within the entity
- Analytical procedures
- Observation and inspection
- Prior period knowledge/information – consider if there has been changes that could affect the relevance of this information to the current year's audit
- Client acceptance or continuance process – evaluate if information obtained during the process is relevant to current audit.
- Discussion by the audit team of the susceptibility of the financial statements to material misstatement.

- Information from other engagements undertaken for the entity: auditor should consider whether information from these is relevant to identifying risks of material misstatement.

Self-assessment question

1. In line with ISA 315 an auditor should gain an understanding of the entity and it environment when planning an audit. What information about the entity should the auditor strive to obtain in order to meet this requirement?

2. Describe the procedures an auditor should use while trying to obtain an understanding of the entity and its environment.

b. Assess Risk of Material Misstatement of the Accounts

To obtain assurance that financial statements are free from material misstatements, the auditor will need to identify possible areas of risk (sources of misstatements) through risk assessment. A risk assessment helps the auditor to ensure that key areas more susceptible to material misstatement are adequately investigated and tested during the audit.

Professional Scepticism and Professional Judgment

In order to achieve the overall audit objective(i.e. to obtain assurance that financial statements are free from material misstatements), ISA 200 requires that the auditor needs to plan and perform the audit with professional scepticism and apply professional judgment, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

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

This requires the auditor to be alert to:

- Audit evidence that contradicts other audit evidence obtained;
- Information that brings to question the reliability of documents and responses to enquiries to be used as audit evidence;
- Conditions that may indicate possible fraud; and
- Circumstances that suggest the need for additional audit procedures and tests.

Professional scepticism is needs to be maintained throughout the audit to reduce the risk of;

- Overlooking unusual transactions
- Over-generalising when drawing conclusions and
- Using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating the results of them.

*Professional Judgment*s the application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional judgment is required in the following areas:

- Determining materiality and audit risks
- Determining the nature, timing and extent of audit procedures
- Evaluation of whether sufficient appropriate audit evidence has been obtained
- Evaluating management's judgments in applying the applicable financial reporting framework and
- Drawing conclusions based on the audit evidence obtained.

The known audit strategies/approaches are vouching/substantive/transaction cycle approach, systems approach and risk-based approach. These approaches will be explained later in this unit. There is, however, increased use of the risk-based auditing approach due mainly to the growing complexity of the business environment which has increased the danger of misstatements due to fraud.

Risk-based approach to auditing

At the planning stage, as required by ISAs 300 and 315, the auditor will identify and assess the main risks associated with the business to be audited. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. The risk-based approach to auditing should enable the auditor to then conclude whether a 'true and fair view' is presented by the financial statements.

Management Assertions Embodied in Financial Statements (Audit Objectives).

Every financial statement presented by management embodies the following assertions:

1**. Existence or occurrence –**Assets, liabilities and owners' equity accounts reflected in the financial statements exist/occurred.

2**. Rights and obligations**: The client has rights to the assets and obligation to pay the liabilities that are included in the financial statements.

3. **Valuation or Allocation**: Assets, liabilities, owners' equity, revenues and expenses are presented at amounts that are determined in accordance with GAAP, that is, balances and transactions are stated at the appropriate values.

4. **Completeness:** All transactions, assets, liabilities and elements of owners' equity that should be presented in the financial statements are included.

5. **Accuracy:** That all balances and transactions are recorded accurately.

6**. Cut-off/timing:** All transactions are recorded in the appropriate period.

7**. Presentation and Disclosure:** Accounts are described and classified in the financial statements in accordance with GAAP, that is, in appropriate categories and all material disclosures are provided.

Any financial statement certified true and fair by the auditor thus constitutes an audit risk in that the assurance affirms that the above spurious assertions are correct.

Audit Risk is the risk that the auditor draws an invalid conclusion and gives an inappropriate opinion when the financial statements are materially misstated. Audit risk is the risk (chance)

that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. Audit risk cannot be completely eliminated; some level of risk will have to be accepted. Therefore, an auditor will need to quantify its acceptable level of audit risk. Acceptable audit risk is therefore a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed (Arens & Loebbecke 2000). For example, if the audit risk is 5%, this means that the auditor accepts that there will be only a 5% risk that the audited item will be misstated in the financial statements, and a 95% chance that it is materially correct.
Audit risk is assessed at the organizational level i.e. looking at the financial statements/accounts as a whole and at the transaction level, i.e. in each of the transaction caption such as stocks and WIP, cash, sales, capital expenditure, purchases etc. Whether at the organizational level or at the transaction level, the approach to audit risk assessment is the same.

Assessing the Risk of Material Irregularity/Misstatements

Material misstatements may arise from irregularities including fraud. In assessing the risk of material irregularity, the auditor may wish to consider the following areas:

a. The Business Environment:

i. Nature of the business, its products and services e.g a company selling mainly on cash basis runs greater risk of misappropriation of its income (cash).

ii. Circumstances that may exert undue influence on management such as holding of shares by the management.

iii. The soundness and/or complexity of the accounting methods.

iv. Transactions with related parties.

v. Company performance – creative accounting/deliberate distortion of financial statements to meet profit forecasts.

vi. Management integrity, including tax evasion.

b. Control Environment

i. Strength, quality and effectiveness of management.

ii. Competence of control personnel

iii. How good is the segregation of duties?

iv. Existence and effectiveness of the internal audit function.

v. Existence of unusual transactions.

vi. The recruitment and training processes/programs

vii Management's over all control – the extent of supervision

viii. Excessive authority vested in a senior staff.

The procedures adopted by the auditor for the purpose of detecting material errors and misstatements/irregularities during an audit will depend on his judgment regarding:

a. the extent of directly relevant legislation.

b. The relative effectiveness of different audit tests.

c. The risk that a particular type of irregularity, error or breach of relevant legislation could impair the true and fair view of the financial statements.

d. The risk that such irregularity can occur and remain undetected by the company.

The audit risk model/Elements of audit risk

Audit Risk = Risk of material Misstatement x Risk of Non-detection by the Auditor

Inherent Risk x Control Risk x Detection Risk

(Financial Statement risk)

As shown above, a firm's audit risk is derived from an assessment of the following elements:

1. Inherent Risk (IR): This is the risk of a material misstatement occurring in an assertion assuming no related internal controls, that is, items are misstated as a result of their inherent characteristics. This risk is derived from the nature of the client or industry and its environment or at the transaction level, it is the susceptibility of transactions to possible misstatement as a result of their nature or complexity.

Factors that influence inherent risk include:

At the financial statement level -

i. The nature of the entity's business e.g a construction company is a more volatile business than a beverage company.

ii. The level of competition in its market.

iii. The integrity, quality and experience of its management.

iv. The financial stability of the company- at present and in the foreseeable future.

v. The complexity of its operations.

At the transaction level, inherent risk is affected by :

i. The susceptibility of the company's assets to fraud and misappropriation

ii. the complexity of the transactions

iii. the degree of judgment/subjectivity involved in processing and recording the transactions.

2. Control Risk: The risk that the client company's internal control procedures will fail to prevent or detect a material misstatement in an assertion or error in the final statements. Factors influencing control risk include:

a. The control environment – that is, attitude of management and directors towards internal control.

b. The level of supervision by management

c. The integrity of staff and management

d. The strength of individual controls in each area of the system and the competence of the accounting staff.

e. The nature of accounting systems in operation – manual or computerized.

3. Detection Risk: The risk that the auditor's own procedures and review of the financial statements will not detect material misstatements. That is, the risk that the auditor's own procedures will lead him to conclude that a material misstatement does not exist in an assertion when in fact such assertion does exist. Factors that influence detection risk include:

a. Recruitment procedures of the audit firm.

b. use of latest audit techniques and procedures

c. The method and timing of audit working paper review.

Note: The detection risk can be managed by the auditor in order to control the overall audit risk. Inherent risk cannot be controlled because it operates independently of controls. Control risk can be reduced by improving the quality of internal controls; however, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. Audit risk can be reduced by increasing testing and reducing detection risk**.**

Audit Risk Estimation/Evaluation

Assessing and evaluating risk is the core of every audit. To assess audit risk, the auditor performs **four** tasks:

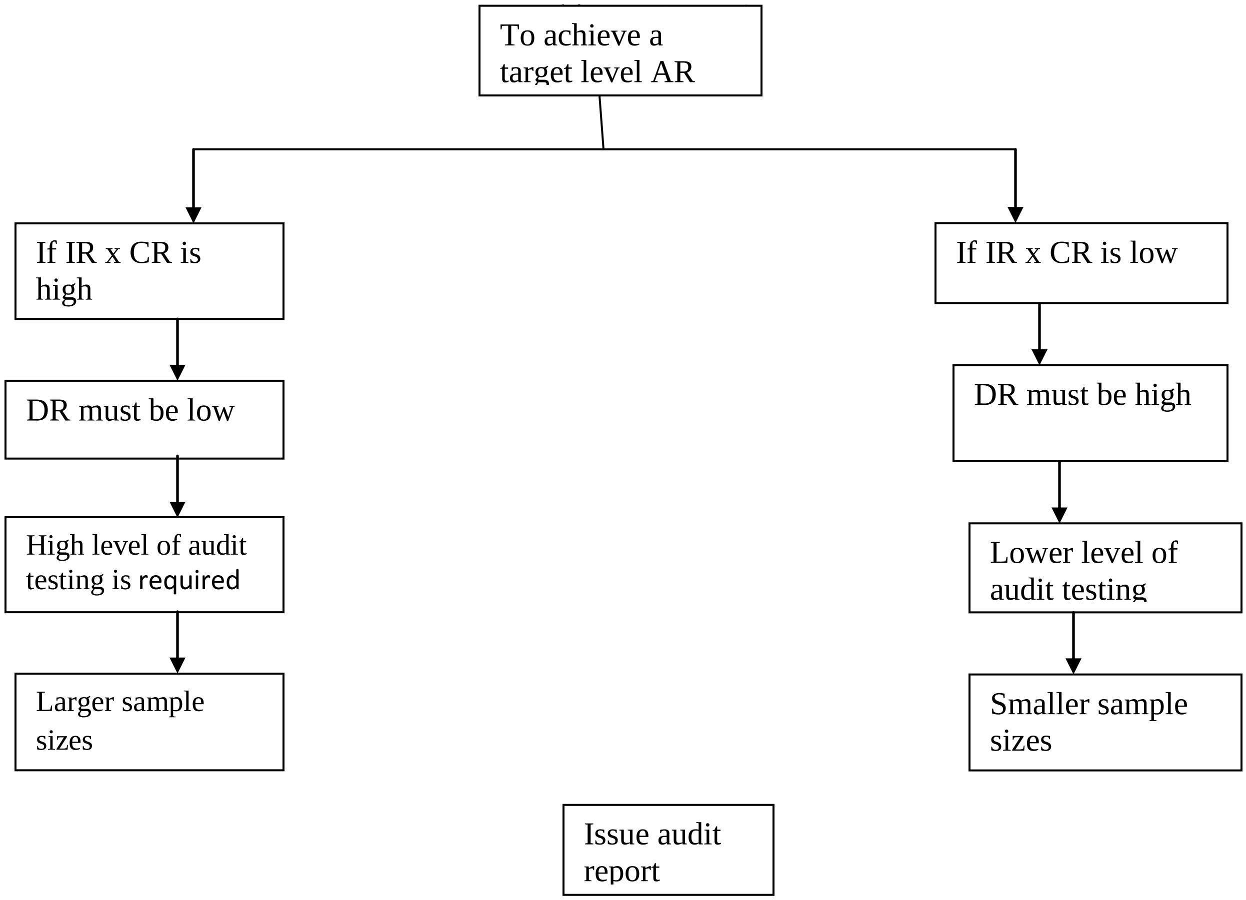
1. Identify risks by developing an understanding of the entity and its environment, including relevant controls that relate to the risks, key transactions, fairness of account balances and key financial statement disclosures.
2. Relate the identified risks to what could go wrong in management's assertions about completeness, existence, valuation, occurrence and measurement of transactions or assertions about rights, obligations, presentation and disclosure.
3. Determine whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
4. Consider the likelihood that the risks will result in a material misstatement of the financial statements and their impact on classes of transactions, account balances and disclosures.

Audit risk estimation involves estimating the various elements of audit risk with a view to determining an acceptable audit risk and thus determine the level/depth of substantive procedures to be adopted during the audit. Recall the audit risk equation: AR = IR x CR x DR. Suppose the IR of a material misstatement of the inventory value total is 80% (that is, there is 80% chance of an error occurring) but the internal control is strong and the non-detection by controls (i.e control risk) is low, say 20% chance of non-detection. At this stage, the risk of material misstatement in inventory total and the internal control not being able to detect it is 20% x 80% = 16%. Assume the detection risk is 30% (that is, 30% chance that this misstatement will not be detected by the audit test) then the audit risk, AR = 30% x 16% = 4.8%. If the auditor desires 95% confidence level and risk level of 5% (i.e 5% risk that the financial statements are materially incorrect), then this 4.8% will be acceptable. If the audit risk turns out to be unacceptable, say 10%, then the auditor has to plan and execute further substantive tests.

Note that in the equation, DR is inversely related to IR and CR. If combined IR and CR is high, acceptable detection risk needs to be low to reduce AR to an acceptably low level. In this case, more substantive testing is needed.

Audit risk assessment: A summary

The implications of this approach for the audit work can be summarised as follows:



Source: ICAN (2014) Advanced Audit and Assurance Study Text.

In the left hand column, to compensate for the high IR x CR, the detection risk needs to be low. This implies extended testing and hence larger sample sizes.
In the right hand column, assessed IR x CR is low; therefore the auditor is comfortable to accept high detection risk. In this case, there may not be extended testing and hence can adopt smaller sample sizes.

Significant Risks

Significant risks are risks that require special audit consideration. They often relate to areas susceptible to management override of controls, judgmental matters and significant non-routine transactions and require special audit consideration. Judgment is used in the development of accounting estimates. Non-routine transactions are unusual transactions, either due to size or nature and thus occur infrequently. Risks of material misstatements may be greater for significant judgmental matters and non-routine transactions.

Benefits of Audit Risk Assessment

1. Reduces the possibility of under- or over- auditing.
2. Saves audit costs and fees.

3. Results in more effective and efficient audit work
4. Focuses the auditor's attention on factors which are more likely to result in misstatement.
5. Facilitates the use of sampling and the attendant benefits derivable therefrom.

Limitations of Audit Risk Assessment

a. Subjective values are placed on IR and CR.
b. May lead to mechanical approach to auditing which may lead to a loss of auditor's judgment.
c. The assignment of risk levels are often not suitably specific which puts into question the validity of conclusions reached.

Factors that may Minimize Audit Risk

Audit risk may be lower if the following positive factors are identified:

1. The enterprise is financially stable without excessive debts and is likely to remain so in the foreseeable future.
2. The enterprise is profitable (for a profit oriented enterprise)
3. The internal controls are strong and the accounting personnel are competent.
4. Past audit experience has provided evidence of good accounting controls with no major audit problems.
5. The proprietor takes active role in the management of the business.

The connection between business risk, financial statement risk and audit risk

There is a connection between business risk, financial statement risk and audit risk.
Business risk: Business risk is the risk inherent to the entity in its operations. It is any risk that threatens the ability of a business entity to achieve its objective – profit maximization or wealth maximization. Any threat to this objective is therefore a risk that profits might be lower, or that the entity might incur losses and even that the going concern status of the business entity might be called into question.
Business risk is resolved into three components. These are
Financial risks, that is, risks arising from the financial activities or financial consequences of an operation, e.g. cash flow strain as a result of overtraining.
Operational risks, that is, risks arising in connection with the entity's operations e.g., loss of a major customer or supplier that adversely affect the continuity of operations of the entity.
Compliance risk, that is, a risk arising from non-compliance with the laws and regulations that govern the operation of the entity.

Where the probability of occurrence of a business risk is low or the severity of the loss arising from its occurrence is low, the risk can be regarded as acceptable. The cost of control measures to reduce the risk would not justify the benefits from the lower risk.
A business risk becomes an *applicable risk* when the financial impact of the risk could be high.

For applicable risks, management should decide on a suitable plan or strategy for managing the risk. The chosen strategy might be any of the following.

i. Reduce the risk by introducing more internal controls.
ii. Transfer the risk, for example by insuring against it.
iii. Avoid the risk entirely, by withdrawing from the business operations to which the risk relates.
iv. Accept the risk, and take no action to reduce it or transfer it.

Business risk and financial statement risk

Most business risks translate to financial statement risks as they increase the likelihood that the financial statements could be materially misstated. Some business risks can be linked to specific financial statement risks such as the risk of:

a. an understatement of bad debts or the allowance for doubtful debts
b. over-stating the value of inventory (where net realisable value is less than cost)
c. over-stating the value of a non-current asset (tangible or intangible) due to a failure to recognise impairment.

Some business risks do not create any specific financial statement risk, although they might ultimately lead to going concern problems for the business entity.

Audit risk and financial statement risk

Business risk is risk that management must deal with. Audit risk is a risk that faces the auditor. It is the risk that the auditor will give an inappropriate audit opinion when the financial statements are materially mis-stated). Audit risk flows from financial statement risk. The auditor should therefore assess the financial statement risks as a step towards assessing the audit risk.

Business risk	Business risk could lead to financial statement risk.
↓	
Financial statement risk	Financial statement risk affects audit risk.
↓	
Audit risk	Audit risk results from inherent risk, control risk and detection risk.

Most of audit risks are identifiable as financial statement risks. The types of risk that could be linked to financial statements include the following:

i. *Risk of over-statement of revenue or other income*: There may be some risk that revenue has not been recognised in accordance with the requirements of IAS18 *Revenue*, and is over-stated.
ii. *Risk of over-statement of current assets*, for example, overstatement of Receivables (insufficient provision for doubtful debts) and overstatement of closing inventory. Both actions will equally overstate profits.

iii. *Risk of over-statement of non-current assets*, e.g. where indicators of impairment have not been considered and the carrying amount of the assets has not been adjusted for impairment.

iv. *Risk of under-statement of liabilities*: There may be a risk that some liabilities are not fully stated, particularly provisions.

v. A company may make a provision for the cost of repairs to fire damage, when the losses were insured, but ignores the amount recoverable through the insurance claim. In this case profit (and other receivables) would be understated.

vi. *Risk of understatement of operating expenses*: Elements of cost usually move in sympathy with revenue. A sharp decline of the ratio of costs to sales may indicate a risk of under-statement of operating expenses.

vii. *Risk from accounting estimates*: The auditor should check accounting estimates carefully. These rely on management judgment and when estimates are a material amount there will be a significant risk of misstatement.

viii. *Failure to comply with the requirements of specific accounting standards*: There may be the risks of misstatement or non-disclosure due to a failure to comply properly with the requirements of the accounting standard.

Self-assessment question

Discuss the elements of audit risk, highlighting the factors that influence each element.

c. Set Materiality Level *(Ref. ISA 320 Materiality in Performing and Planning an Audit)*

General principles

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. The assessment of materiality is always based on the judgment of the auditor applied to the circumstances of a particular case. Materiality depends on the size and nature of an item judged, based on the surrounding circumstances.

Materiality is a relative factor. An amount that is material in the financial statements of one company may not be material in the financial statements of another**.**

Materiality thresholds/Baseline Materiality levels

In order to deal with materiality on a consistent basis, most audit firms set their own ‘materiality thresholds’. Their audit staff is trained to use these thresholds to ‘measure’ whether or not an item is material.

Materiality thresholds vary from one firm to another, but will typically fall within the following ranges:

Revenue 1% – 2% (1/2 – 1%): An item of revenue is material if it is at least 1% to 2% of annual sales revenue or ½% to 1% of revenue

Profit before tax 5% – 10%:	An item is material if it is at least 5% to 10% of reported pre-tax profit.
Total assets 1% – 2%	A balance is material if it represents at least 1% to 2% of total assets.
Net Assets 2 – 5%	A balance is material if it represents at least 2% to 5% of total assets.

Note: Materiality is a matter of judgment for the auditor. Prescriptive rules are not helpful because there would be the risk that a significant matter which falls outside the boundary of the rules could be overlooked, leading to a misstatement in the financial statements.

Factors that the auditor should consider in evaluating materiality may include the following:

- The *nature* of the item involved – The valuations of some items in the financial statements are more subjective than others, and depend on estimation. The more subjective the item, the more flexible the auditor should be in assessing the materiality of possible misstatements. The auditor will have to take a very different view on materiality when considering a warranty provision (which is a subjective estimate), compared with the approach taken when auditing share capital, which is capable of precise measurement.
- The significance*(value)*of the item – Some items may be insignificant in terms of their monetary amount, but may nevertheless be of particular interest to the users of the financial statements. An example might be bonus payments to directors.
- The *impact* of the item on the view presented by the financial statements. A small and apparently insignificant error or omission may be material if, by correcting it:
  - a reported profit is converted into a reported loss, or
  - the correction significantly alters the trend of profits (growth rate in profits) over the past few financial years.

At the planning stage of the audit, the auditor sets materiality thresholds for different transaction cycles, as indicated above to guide the engagement team. ISA 320, also requires that the auditor sets *performance materiality*. Performance materiality recognises the fact there could immaterial errors/omissions which, when added together, would breach the overall materiality level. Performance materiality is a way of taking this risk into account and will be set at a lower figure than overall materiality. Thus, materiality could be looked at on individual item/balance levels as well as in aggregate.

There may be one or more performance materiality levels, as the level could vary by area. As the audit progresses, the auditor must revise materiality (and, if appropriate, materiality for particular areas and performance materiality) if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

Documentation must include details of all materiality levels set and any revision of these levels as the audit progresses.

d. AUDIT PLANNING MEMORANDUM

Definition: Audit Planning Memorandum (APM) refers to the audit plan documentation prepared by the Auditors, containing all of the information obtained and the decision reached in the process of Audit Planning Programme. It is a standing arrangement made by the auditor for the continuing engagement of a particular client. The objectives of Audit Planning Memorandum are to provide formal record of the planning process and the programme, communicated to the Audit team to facilitate the audit process.

CONTENTS OF AUDIT PLANNING MEMORANDUM

The contents of audit planning memorandum can be outlined under five (5) broad categories.

(i) **Background Information of the client**, which covers the following:

- A brief historical background of the entity
- The nature and trend of the enterprise's business.
- The organizational and management structure of the enterprise.
- Significant accounting policies followed by the entity in the preparation of its financial statements.
- The terms of reference of the audit assignment.
- The Accounting and Internal control procedures of the entity.

(ii) **Audit Strategy Memorandum**, which contain the following:

- The audit objectives.
- The overall audit approach
- Audit Risk analysis for the various sections of the financial statements and the approaches to be adopted in respect of each section.
- Areas requiring special audit attention and the procedures to be applied.

(iii) **Jobs or Assignment Administration Memorandum**, which includes:

- The Partner in charge of the Audit Assignment.
- The Manager in charge of the Audit.
- The Seniors and other staff in charge of the Audit.
- Dates of the audit visits including any interim visits, and final audit visit.
- Dates and details of such events as:
    - Manager's field review; Manager's final review;
    - Circularization of Debtors and Creditors;
    - Confirmation of bank balances.
    - Stock takes
    - Cash count.
    - Management Representation Letter.
    - Partner's final review

- Reporting deadline.
- The Audit time Budget
- The Audit Procedures.
- (iv) Audit Programme

(iv) Audit Programme

This section of the Audit Planning Memorandum usually contains programme for the various sections of the audit work specified, e.g. compliance and Substantive Audit Procedures.

(v) **Summary Review Memorandum**

This section relates to standard formats of job requirements or scope of work carried out, and standard information to be supplied as evidence of work done, to guide the review of audit performance. It includes communication with auditors of groups (primary and secondary auditors) concerning matters of audit interest; including summary of audit differences.

Benefits of Audit Planning Memorandum

(i) Assists in the review of audit work.
(ii) Shows logical approach adopted in the plan of work
(iii) Serves as a guide for future audit planning.
(iv) Provides evidence of proper audit planning in case of litigation.
(v) It is useful for training audit staff.
(vi) It provides evidence of work performed in case of disagreement on scope.
(vii) It is a basis for comparison of Audit plan and actual performance.

3.3 AUDIT PLAN

An audit plan is an overview of the engagement that outlines the nature and characteristics of the client and its environment and the overall audit strategy. It highlights the preparations made for one specific audit engagement.

A typical audit plan includes details on –

1. Objectives of the audit (e.g reporting to shareholders, special- purpose audit or reporting to any other party).
2. Nature and extent of other services to be performed for the client e.g taxation services.
3. Timing and scheduling of the audit work – what to do before balance sheet date, on the balance sheet date or after, including dates for cash count, observing of inventory, third party confirmations/circularization.
4. Description of the client company and its environment.
5. Work to be done by the client staff eg production/presentation of T/balance, schedules, reconciliations etc
6. Staffing requirements during the engagement.
7. Discussions among team members about significant risks.
8. Target dates for completing major segments of the engagement eg consideration of internal control, audit report, filing of tax returns etc

9. Significant risks of material misstatement due to fraud or error and auditor's response to those risks.
10. Preliminary judgments about materiality levels for the engagement.

    With respect to the auditor's consideration of fraud, it is important to document in the audit plan the following –

i. Discussions among team members about fraud risks held during planning.
ii. Procedures performed to identify fraud risks.
iii. The fraud risks identified and the response to those risks.
iv. Any other conditions that caused the auditors to perform additional fraud related procedures.
v. The nature of any communication made to management, audit committee or any other party about fraud.

Note: Audit plan is drafted before the start of work at the client's office but may be modified throughout the engagement as special problems are encountered and areas requiring more or less audit work emerge.

3.4 Preliminary Engagement Activities

Prior to planning any current engagement, the auditor performs some preliminary engagement activities. These include:

i. Procedures regarding the continuance of the client relationship and the specific audit engagement. He needs to find out if there are issues with management integrity that may affect the auditor's willingness to continue with the engagement. There is also the need to ensure that there is no misunderstanding with the client as to the terms of the engagement.

ii. Evaluation of compliance with ethical requirements, including independence.

iii. Establishing an understanding of the terms of the engagement.

Note: Procedures (i) and (ii) occur throughout the performance of the audit as changes in circumstances occur.

3.5 The Planning Process (Points for Consideration in Audit Planning

It is important that the planning is documented in a document called the Audit Planning Memorandum.

The planning process will involve:

1. Review of previous years' working papers for key issues and problem areas (for a continuing engagement).
2. Considering the impact of any changes in legislation, auditing or accounting standards, especially in relation to their effects on the operations and/or reporting requirements of the enterprise.
3. Considering the background of the client and any changes in the industry or issues that may affect the audit work.
4. Considering changes in the business, its management or ownership. A change in the CEO, CFO, a new management structure, establishment of a new business line, new branch etc will result in significant changes in the circumstances of the company that will affect the audit plan.

5. If there are changes in systems, accounting procedures and policies, review their effect on the audit.
6. Carry out analytical review of management accounts and note key performance indicators (KPIs).
7. Decide on the audit approach (substantive, systems-based or risk-based).
8. Agree on timing of the audit work – interim, final including established deadlines for the submission of audit report.
9. Agree on time for availability of draft accounts, supporting schedules, analyses and summaries by client.
10. Evaluate internal controls and decide on level of reliance to be placed on them.
11. Consider the use of experts, if necessary, and incorporate in plan.
12. Plan rotational visits and testing, where many branches exist.
13. Work out time budget.
14. Plan and arrange staffing requirement and decide on likely fee chargeable.
15. Organize liaison with the audit committee (if any) and joint auditors, in case of group audits.

3.6 BENEFITS OF AUDIT PLANNING

Adequate planning helps to ensure that:

1. The audit objective is established and achieved.
2. Attention is devoted to important areas of the audit, that is, to critical and high risk areas.
3. Potential problems are identified and resolved on timely basis.
4. The resources needed for the engagement, including the use of experts, are identified and procured.
5. Works are properly/appropriately assigned to engagement team members.
6. The audit engagement is properly organized and managed for effectiveness and efficiency.
7. The direction and supervision of the audit, including the review of the works of team members, are facilitated.
8. The co-ordination of the works of joint auditors (in the case of a group audit) and experts are facilitated.
9. The audit engagement is completed economically and within time schedule.

3.7 DECIDING ON AUDIT STRATEGY

The audit strategy sets the scope, timing and direction of the audit and guides the development of detailed audit plan. Establishing the audit strategy involves –

a. Determining the characteristics of the engagement that define its scope, such as the reporting framework used, industry-specific reporting requirements (eg banks, insurance companies etc) and the location of the components/branches of the entity.
b. Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of communication required (eg deadlines for interim and final reporting,

key dates for expected communication with management and those charged with Governance.

c. Considering the important factors that will determine the focus of the engagement team's efforts e.g. preliminary determination of high risk areas, determination of appropriate materiality levels, and assessment of the strength of internal control, identification of recent entity-specific, industry financial reporting or other relevant developments.

3.8 FACTORS TO CONSIDER IN DETERMINING AUDIT STRATEGY

1. Auditor's responsibility under the terms of the engagement: In addition to regulatory or statutory requirements (e.g Company's Act provisions regarding audit), the auditor should consider whether additional responsibilities arise from request by the client's management such as accountancy or taxation work or because the client is required to conform to special regulatory requirements.

2. The nature of the client's business and organization: It is essential to have a good knowledge of the client's business as well as the industry in which it operates, including its products and services, important customers, significant contracts and suppliers, the accounting system, the control environment (directors and mgt.'s attitude to internal control) etc.

Knowledge about the business and organization could be obtained from –

- Company's interim and management accounts, including annual reports and procedures manual.
- Previous years' audit files
- Published materials about the client's company and the industry
- Policy statements and minutes of board and committee meetings.
- Legal documents – MEMART, lease and loan agreements, feasibility reports etc
- Tour of the principal places of business.

3. The nature and significance of items in the accounts: A very important factor in the determination of audit strategy is a review of the recent accounts and other financial information to assess the significance of items appearing in the balance sheet. Obtain information on the nature and approximate volume of transactions resulting in significant account balances. Subject insignificant account balances to limited audit procedures.

4. Key features of the entity's accounting system and the effectiveness of the control system: To evaluate the potential for reliance on internal control in respect of significant items in the accounts, it is essential to gain a preliminary understanding of the key features of the entity's accounting system that gave rise to the items together with the related internal controls. Note methods of and control over processing and recording of significant transactions/items. Document your preliminary understanding and evaluation of the potential for reliance on internal control. Any apparent weakness in internal control should be brought to the attention of the client.

Summary of steps for preparing Audit strategy

i. Identify/State the client to be audited and the relevant reporting period/year end.

ii. Identify the key characteristics of the client, that is, the nature of the client business and the industry in which it operates.

iii. State the type of audit to be conducted and the financial reporting framework.
iv. Give key dates/timing (i.e. timetable) for various stages/aspects of the audit – interim, final, staff briefing meeting, meeting with audit committee, approval of financial statements by management, issue of final report.
v. Overview of the audit approach
vi. Materiality determination/setting materiality levels for various transaction cycles
vii. Risk assessment and identification of high risks areas
viii. Specific audit approach and extent of compliance/substantive testing required.
ix. Review of events after the reporting period – areas of focus.

3.9 AUDIT STRATEGIES

The three broad audit approaches are:

1. **Vouching/Substantive Approach:** This approach is often adopted for the audit of small organizations where the internal control system is weak, there is limited number of staff and therefore there is great need to test a large number of transactions. This audit approach involves complete examination of the transactions of the business together with the documentary evidence of sufficient validity to satisfy the auditor that the transactions are in order, properly authorized and accurately recorded. The auditor traces the transactions to their sources in order to ascertain their full origins and meanings.

Generally, vouching audit is useful in:

(i) Very small organizations with few transactions.
(ii) Organisations where the systems of internal control is weak or nonexistent
(iii) Specialised audits which require investigations such as those of trust, estate, church, mosque, charity etc.
(iv) Checking of non-recurring, material, unusual and extraordinary items.
(v) When the auditor is put on enquiry

2. **Systems-based Approach:** This approach relies on the controls contained in the client's financial system to validate accounting records. It is a system to determine what reliance can be placed on the established controls to ensure that resources are being managed effectively and financial information provided accurately especially for reporting purposes. Additionally, a system based audit is an audit of the internal controls in a system. The auditor tests the controls by means of testing a sample of transactions taken to be representative of the types of transactions checked by the particular control or set of controls the auditor is testing.

Two procedures may be adopted in a system audit:

- Compliance tests which seek evidence that a good and reliable system of control as established in the organization is being maintained.
- Substantive tests are designed to ensure that the system of controls that have been established continue to operate at all times confirming the validity, completeness and accuracy of recorded transactions. The essence is to determine whether especially, because of the volume of transactions, the sample of the population selected for testing is representative of the whole population for the purpose of expression of opinion thereof.

Moreover, any balance sheet items or unusual transactions which have not gone through normal accounting system are subjected to detailed testing (substantive testing).

Generally, Systems Audit is useful in the following areas:

(i) Tests seeking evidence that the internal controls are being applied as prescribed. These are called compliance tests.

(ii) Once the compliance tests have been completed, further tests may be required to substantiate the entries in the figures in accounts and the evaluation of financial information by a study of plausible relationship among both financial and non-financial data.

(iii) When an auditor investigates a system by identifying the control objectives of the system and evaluating the system's internal control on paper, the auditor should determine whether the internal controls that currently exist appear to be adequate.

3. **Risk-based Auditing/approach:** This approach is adopted for very large organizations or organizations with excellent internal control system. It is an efficient way of auditing large organizations where errors or misstatements have to be fairly large to have any impact on the financial statements. The logic is that errors or misstatements will not arise from wrong recording of transactions but will have their source in identified areas of risk – either operational risks arising from the nature of the business or from the complexity of the accounting system. Thus, the auditor in this strategy carries out a limited amount of testing of transactions and balances and concentrates efforts on analyzing the business risks faced by the organization. The auditor determines, by applying judgment, what levels of risks pertain to different areas of the client systems and designs appropriate audit tests. Emphasis of the audit work is directed at areas in which the financial statements are mostly likely to be misstated materially. In effect, audit costs are likely reduced. The risk that the auditor will give inappropriate opinion is also reduced.

4.0 Conclusion

Planning is essential in the execution and control of every audit. It helps in the determination of the overall audit strategy and in developing an audit plan. Planning follows a defined procedure namely:performing procedures to understand the entity and its environment, including its internal control system; assessing the risk of material misstatement of the accounts; preliminary determination of materiality and preparing the planning memorandum, the audit plan and audit program containing the auditor's response to identified risks.

5.0 Summary

This Unit dwelt on the planning and control of an audit. The four-step planning procedure is discussed in detail. In the process, risk assessment procedures are described and the elements of audit risk highlighted. The relationship between business risk, financial statement risk and audit risk is x-rayed. We also examined the audit plan process and the benefits of audit planning. The unit also discussed the 3 common types of audit strategy.

6.0 Tutor-marked assignment

1. The audit process has evolved from vouching and systems based audits to risk-based auditing.

Required:

1(a). Give brief descriptions of each of the **three** types of audit approaches stated above.

(b) State the instances where vouching and systems audits are still applicable.

(ICAN adapted)

2. Planning an audit of financial statements involves establishing the overall audit strategy for the engagement and developing an audit plan.

Required:

i). State **six** reasons for audit planning.

ii). Discuss **four** factors to consider in determining audit strategy.

3. Explain the term “audit risk” and discuss the elements of audit risk.

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011**).** Auditing, 11th Edition, London: BookPower/ELST
2. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International
3. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.
4. International standards on Auditing 200, 300 and 315.

UNIT 9: THE USE OF COMPUTERS IN AUDITING

Content

1.0 Introduction

To be considered at the planning stage of an audit is the impact of computer systems on the audit process. Both the auditor and the client are usually affected. First, the auditor may use computers in the planning, execution and reporting on the outcome of his audit work. Secondly,the client's accounting systems may be computer-based in which case the auditor may be concerned with the effectiveness of the controls that are in place for the system and the need to deploy computer-assisted audit techniques (CAATs) in doing some of the audit work.

In this unit, we discuss these two dimensions in our consideration of auditing in a computer-based environment.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the need for controls over both the auditor's and clients computer systems
- Distinguish between general IT controls and application controls
- Identify and discuss the commonly used types of CAAT tools
- Explain the possible solutions to loss of audit trail in a computer environment

- Discuss the advantages and disadvantages of deployment of CAATs in audit
- Discuss the factors to consider in the auditor's choice of audit tests in a computer environment.

3.0 Main Content

3.1 Auditor's use of computers to perform an audit

It is common to find auditors using computers, (mainly laptops in recent times)to perform different tasks during an audit. Such tasks include:

a. audit planning work ,e.g. risk assessments, materiality assessments etc,
b. audit administration and control, e.g. preparing audit work programmes.
c. preparing audit working papers
d. analytical procedures (including holding on file a record of statistics and financial ratios for the client for previous years)
e. sampling software (if appropriate).

Managers and partners can easily exchange mails, review works and direct the field work without visitingthe client office. Thus, the use computers for an audit saves time and travel costs for the audit firm.

3.2 Controls over the auditors' computer systems

When the audit work is performed largely on computers, it is necessary to put suitable controls in place to ensure that:

i. client data remains confidential and cannot be accessed by an unauthorized person
ii. audit work held on computer file cannot be lost
iii. an audit trail is created for the work the auditor has done, to assist the audit review and control process and
iv. the programs operate in the way that they are expected to.

3.3 **Controls in computer-based information**

Controls in a computerized environment include both manual procedures and procedures designed into computer programmes. Two types of controls exist, namely *generalcontrols* and *application controls*.

These controls were treated in your ACC 210 – Audit and Assurance 1 and students are advised to review them and attempt the self-assessment questions below.

Self-assessment questions

1. What are general IT controls?
2. Describe 4 examples of application controls an auditor would expect to find in a computer-based accounting system.

3.4 Microcomputers, On-line systems and Electronic data interchange (EDI)

Many entities use decentralised 'standalone' computers or network systems, which are managed and operated by individuals who are not IT specialists. The use of decentralised systems though efficient for the client, may create additional problems for the auditor, who needs to confirm that the controls within the system are effective.

The following types of system may require special attention by the auditor:

i. microcomputer systems
ii. on-line systems and
iii. electronic data interchange (EDI) systems.

Microcomputer systems

'Microcomputer system' refers to a computer system in which the entity uses a number of stand-alone 'desktop' computers that are located throughout the organisation.

In microcomputer systems, the auditor is faced with:

i. The difficulty of ensuring adequate physical security of the equipment.
ii. Difficulties with ensuring the security of the data and storage media (disks, tapes etc.).
iii. The risk of unauthorised amendments to program or data files, as some unauthorised persons may have access to the system. This risk can be minimised by restricting access to the computer system and to particular program files and data files through the use of passwords and user names.
iv. control risks with respect to processing and the software as programs may be written or modified by the user (one of the potential attractions to the entity of the use of microcomputer systems).
v. Non-provision of adequate documentation of the software systems by the software supplier. If this is the case, it would need to be written by the computer user.

On-line systems

On-line systems are network computer systems that allow users direct access to centrally-held data and programs. Access to the central files is through remote terminals.

On-line systems offer a number of operational advantages to entities that use them.

1. They permit the immediate entry of transactions from many different locations, instead of having to submit transactions to a central computer centre for processing. Data are input through terminals in each location for central ('real time') processing.
2. In the same way, centralised master files (such as master files for inventory) are updated immediately. This means that subsequent users of the system can use the up-to-date versions of master files.
3. On-line systems allow users to make inquiries and obtain immediate responses, by having access to master files or reference files. (For example, users are able to give immediate answers to customers about prices of products or the current status of their order).

In spite of these benefits to the entity, on-line systems create additional problems for the auditor who needs to assess the effectiveness of the system controls. There should be sufficient general controls and application controls to minimise the risks that arise from using on-line systems.

General controls in an on-line system could include the following:

a. There must be effective controls over access to the system and its files. This is because in on-line systems, transactions are processed as soon as they are input.
b. There should be controls written into the system software to prevent or detect unauthorised changes to programs.
c. Transaction logs should be used to create an 'audit trail'. An audit trail refers to the ability of the auditor to trace a transaction through all its processing stages.
d. Firewalls should be used for systems that have access to the Internet. Firewalls are hardware or software devices that prevent unauthorised access to a system from an Internet user.

Application controls in an on-line system could include the following:

i. Pre-processing authorisation (such as logging on to the system, and the use of user names and passwords).
ii. Data validation checks in the software, to check the completeness and accuracy of processing (such as checking that a product code has been entered with the correct number of digits).
iii. 'Balancing' – checking control totals of data submitted from remote terminals before and after processing.

Electronic data interchange (EDI) systems

Electronic data interchange (EDI) systems are systems that allow the electronic transmission of business documents, such as invoices or payroll information, between different computer systems. The EDI system provides a form of 'translation' service, so that the data transmitted from one computer system is changed into a form that can be read by the other computer system, without any need for human intervention.

EDI systems may operate within the organisation (for example, the sales department may use EDI to transfer copies of customer orders electronically to a separate computer system of the accounting department), or externally (for example, a company may use EDI to submit purchase orders for inventory electronically to the computer system of a supplier).

EDI systems can improve the operational efficiency of an entity, but they may generate the following problems for the auditor who has to assess the efficiency of the system controls:

a. The lack of a paper audit trail.
b. An increased level of dependency on the computer systems of the organisation and possibly the computer systems of other entities. Any failure or control weakness in one computer system may have an impact on the computer system that is being audited.
c. There may be a risk of loss or corruption of data in the process of transmission.
d. There will be security risks in the transmission of data.

Possible controls that may minimise the risks inherent in EDI systems include:

i. controls over the transmission of data (such as the encryption of data before transmission, acknowledgement systems, and the use of authentication codes for senders of data)
ii. monitoring and checking of output
iii. virus protection systems
iv. contingency plans and back-up arrangements.

3.5 Computer-assisted audit techniques

CAATs can be defined as any technique that enables the auditor to use computer systems and techniques as a source of generating audit evidence.

CAATs are often necessary in the audit of computer-based information systems because these systems may not provide an adequate audit trail. In addition, since processing is 'invisible' because it is electronic, the auditor needs to 'get inside the computer' to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this objective.

Two commonly-used types of CAATs are:

a. audit software, and
b. test data.

Audit software

Audit software is computer programs used by the auditor to extract information from a client's computer-based information system, for use in the audit. Audit software could be applied in account analysis, e.g. interrogating clients data file for 'exceptions', say items above N1million in the payroll; aged listing of receivables, analytical procedures (calculating ratios and making comparisons) etc

The main types of audit software include:

i. interrogation programs, which accesses the client's files and records and extract data for auditing
ii. interactive software, for interrogation of on-line computer systems
iii. 'resident code' or 'embedded software', to monitor and review transactions as they are being processed by the client's programs. This type of software is called embedded audit facilities.
iv. Comparison programmes, which compare versions of a programme.

The main use of audit software is in substantive audit testing.

Test data

An auditor may use test data to process a sample of transactions through the client's computer-based information system, and compare the results (output) obtained from the processing with the pre-determined results that the auditor would expect. Test data can also be used to check the controls that prevent processing of *invalid data* e.g. an amount, which if processed will breach customer credit limit could be entered to check the system reaction to it. Test data, thus, is used primarily for tests of control. The technique provides evidence that specific application controls are operating effectively in a given system.

One problem with test data is that any resulting corruption of data files has to corrected. This may be difficult with real-time systems, which have inbuilt controls to ensure that data entered cannot easily be removed without leaving a mark.

Another problem with using test data is that it tests the system at *a single point of time* and therefore can only give audit evidence about the computer system at the time the test data is processed. The test data cannot provide assurance that the system and its controls operate effectively at any other time.

Embedded audit facilities

Embedded audit facilities may also be called 'resident audit software' or an 'integrated audit module'. It is audit software that is built into the client's computer system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the auditor to carry out tests at the time that transactions are being processed, in 'real time'.

Procedures are written into the entity's computer-based information system and these generate data for audit purposes every time the system is run. In order to obtain audit data without the risk of corrupting the client's operational data files with the test data, it isusual to establish an extra 'dummy' department.The test data results are allocated to this dummy department, and the test data is therefore kept separate from the client's operational data. Only the auditor should have access to the data stored in this dummy department.

Embedded audit facilities can be very useful for the auditor of on-line computer systems where:

a. data is continually processed and master files are being continually updated, and/or
b. it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

Testing Strategies: Factors to Consider

Auditors' choice of method of testing during the planning of audit in a computer environment will be determined by the following factors:

(i) *Practicabilityof performing audit tests manually*: Many computer based accounting systems perform functions for which no visible evidence is available. In this regard, it will not be advisable for the auditor to use manual testing method.

(ii) *Time availability*: Generally, since the auditor has to report within a short time scale, he may choose to use CAAT as they are quicker to apply, even though manual methods may be more practical and cheaper.

(iii) *Computer facilities availability*: When using CAAT auditors will need to ensure that the required data, computer files and programs are available;

(iv) *Expertise and experience*: Auditors will require at least a basic understanding of the fundamentals of computer processes because they are using the computer to assist them in performing the audit tests before contemplating using CAAT.

(v) Reliance on internal audit functions: Where CAAT is used by a suitably trained internal auditor, it may be of significant assistance. The extent to which the external auditors are able to reduce the level of tests by taking account of computer audit techniques performed by the internal auditor will depend on their assessment of the independence and effectiveness of the internal audit function.

(vi) *Volume of clients' business*: It is not worthwhile to use CAAT where the volume of transactions is small.

Disadvantages of CAATs

CAATs give the auditor the ability to audit the processing of transactions in a computer-based information system. However, the value of using CAATs should be assessed on a cost-benefit basis. CAATs should only be used if the benefits from their use exceed the costs.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping the programs up-to-date, for changes in hardware and software
- training audit staff in their use. CAATs are of no value unless auditors are properly trained in how to use them.
- obtaining time on the client's computer systems to run the CAATs.

Advantages of CAATs

CAATs also have many advantages (which is why many audit firms use them).

- They give auditors an ability to test the completeness and accuracy of the electronic processing itself (the computer software), rather than relying only on testing the accuracy and completeness of inputs and outputs.
- They give the auditor an ability to test a larger number of transactions in a relatively short amount of time: testing larger amounts of data reduces the overall audit risk.
- They allow the auditor to test the effectiveness of controls that are programmed into the computer software.

Loss of audit trail: Possible solutions

A major problem of auditing computer systems is the loss of paper audit trail. Solutions to this problem include the following:

(i) Use of Computer Assisted Audit Techniques to assess reliability.
(ii) Testing on a total basis and ignoring individual items to access report.
(iii)Closer co-ordination between internal and external auditors to bridge gaps in compliance tests.

(iv) Arranging for special print-outs of individual information for the auditors to attempt to re-create transaction trail.
(v) Clerical re-creation of individual items of data for comparison with computer generated totals.
(vi) Programmed interrogation facilities whereby records held on magnetic files are printed on a selective basis by means of direct request to those files.

4.0 Conclusion

The Computers is useful in the audit process in two ways, namely, the auditor needs it in the administration and execution of the audit assignment and the client needs it for its financial reporting and other administrative job. However, the use of computers introduces a new dimension of risk, especially in the area of control and audit trail. Thus, the auditor is concerned with both manual and automated controls around and within the computer systems. Thus, the use of Computer assisted audit tools and techniques (CAATs) is imperative for the auditor when auditing in a computer-based environment.

5.0 Summary

This unit discussed the types of computer systems found in a computer environment. It also highlighted the general IT and application controls expected in a computer-based systems, the types of CAATs that could assist the auditor in the audit of computer-based accounting systems and the advantages and disadvantages of using CAATs.

6.0 Tutor-marked Assignment

1. The availability of Computer Assisted Audit Techniques (CAATs) should be considered by auditors when planning the nature, extent and timing of tests in an audit. Auditors must determine their testing strategies which will depend on their choice of either using a manual testing method or computer assisted method.

Required:

a. Explain **FIVE** factors that will determine auditors' choice of method of testing in the planning of audit in a computer environment. (10 Marks)

b. Identify **FIVE** solutions to loss of audit trail. (5 Marks)

(Total 15 Marks)

2. You have been appointed Auditor of a company whose accounting transactions are processed using the computer. You have decided to use Computer-Assisted Audit Techniques (CAAT) to generate evidence for the audit assignment.

Required:

a. State **FOUR** advantages and **THREE** disadvantages of using test data in compliance testing of application controls. (7 Marks)

b. List **FOUR** activities for which audit software may be used to perform substantive tests by the auditor. (4 Marks)

c. List **TWO** advantages and **TWO** disadvantages of the use of audit software.

(4 Marks)

(Total 15 Marks)

7.0 References/further reading

1. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.
2. Millichamp, A.H & Taylor, J.R (2011)**.** Auditing, 11th Edition, London: BookPower/ELST
3. ICAN(2014).Advanced Audit and Assurance Study text. UK: Emile Woolf International
4. ICAN (2015). Pathfinder, May 2015 professional level examinations

UNIT 10: AUDIT TESTING, SAMPLING AND ANALYTICAL PROCEDURES

Content

1.0 Introduction

In this unit, we examine the types of audit testing, sampling as a tool of audit testing and analytical procedures as both a risk assessment procedure and a substantive audit testing procedure.

2.0 Objectives

By the end of this unit, you should be able to:

- Understand the two forms of audit testing
- Explain the importance of sampling in audit testing
- Discuss the importance of analytical procedures in the planning and conduct of audits
- Conduct analytical procedures on a sample set of financial statements

3.0 Main Content

Audit tests comprise a combination of –

- ❖ Inspecting for evidence that control has been operated as described
- ❖ Re-performing the accounting procedure on a sample of transactions, in either direction to ensure they have been carried out correctly
- ❖ Carrying out substantive tests on balances and reconciliations including obtaining independent evidence and analytical reviews.

3.1 Forms of Audit Testing

a. Compliance tests
b. Substantive tests.

a. Compliance Tests: These are tests which seek to provide audit evidence that internal control procedures are being applied as prescribed. They are tests to obtain audit evidence about the effective operation of the control environment and in particular, the operation of the control procedures.

In compliance tests, the auditor tests the application of the control procedure and not the transaction itself, though the testing is through the medium of the transaction. For example, suppose that a system provides that all credit notes issued by a company must be approved by the sales manager. To test whether the control operates as prescribed, the auditor will inspect a sample of credit notes to see if they have been approved/initialed by the sales manager. The details of the credit note e.g. coding, calculations etc are not relevant to the test being performed. In the test of controls, the auditor looks at 5 components of an entity's internal control viz.

i. The control environment – the control culture of the entity and its impact.

ii. The entity's own risk assessment process – how the entity identifies, assesses and responds to its business risks.

iii. Information systems relevant to financial reporting – those systems related to the capture of significant transactions, events or accounting activities, data entry of transactions etc.

iv. Control activities relevant to audit – those policies and procedures that help ensure that management directives are carried out (i.e control activities designed to prevent/detect misstatements) e.g controls on authorization, performance reviews, information processing, physical controls and segregation of duties.

v. Monitoring control activities – activities that entity uses to monitor control activities over financial reporting as well as how it takes actions to address any identified deficiencies.

Where from preliminary review of the system of controls, the system appears weak or defective, the auditor may need to abandon the systems approach and apply substantive testing/approach.

b. Substantive Tests: Substantive tests are those tests of transactions and balances and other procedures such as analytical reviews, which seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or the financial statements. All tests other than tests of control are substantive tests. Thus, substantive test is any test which seeks direct evidence of the correct treatment of a transaction, a balance, an asset, a liability or any item in the books of account. Substantive tests are designed to obtain audit evidence to detect material misstatements in financial statements.

Substantive tests are comprised of analytical procedures and other substantive procedures such as tests of details of transactions, review of minutes of directors' meetings and enquiries.

Examples:

i. **Transaction (e.g Disposal of item of fixed asset):** Auditor will need to examine the authorization, copy of the invoice, the entry in the fixed asset register and other books, the accounting treatment and evidence of due process in selecting the buyer and that a reasonable and appropriate price was obtained.

ii. **Account balance (e.g bank deposit balance):** In addition to inspecting the deposit certificate, auditor seeks direct confirmation of the balance from the bank.

iii. **Analytical Review (e.g stock cut-off procedure):** Auditor seeks evidence of correctness of cut-off by examining the gross profit ratio.

iv. **Accuracy of information (e.g directors' remuneration**): Obtaining from each director a confirmation that an accurate statement of remuneration and expenses had been obtained.

v. Completeness of information(e.g legal expenses): obtaining confirmation from the legal adviser that all potential payments/liability from current litigation had been considered.

vi. Validity of information (e.g stock in transit): Auditor seeks evidence of ownership and shipment.

3.1.1 Techniques of Audit Testing

Same as techniques for obtaining audit evidence and include:

- Inspection (of documents, procedures, tangible assets etc)
- Observation
- Inquiry
- Confirmations
- Computations
- Re-performance
- Sample testing
- Analytical procedures

3.2 AUDIT SAMPLING (ISA 530/NSA 18)

In many organizations, it is almost impossible within the time frame for the audit to do 100% examination of transactions and items. Thus, the auditor may try to obtain audit evidence about the population by selecting and examining specific items based on such factors as his understanding of the entity, the assessed risks of material misstatement and the characteristics of the population being tested and/or sampling the population. A sample is thus a representative of a population (universe of data) and audit sampling involves the application of audit procedures to less than 100% of items within an account balance or class of transactions such that all sampling units have a chance of selection.

3.2.1 Basis of Sampling

ISA 530/NSA 18, states: "when designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of the audit procedures.'

The objective of all sampling is to draw conclusions about a large volume of data, the population, based on an examination of a sample taken from that population. Sampling is most often used in compliance testing but can also be applied to tests of balance sheet items like stocks, accounts receivable, suppliers, fixed assets etc.

For sampling to be meaningful as a procedure:

1. the population should be homogeneous – every item in the population have the same characteristics/be of the same type e.g. purchases invoices and not a mixture of purchases invoices and debit notes.
2. every item on the population must have an equal chance of being selected.

Note that sampling may not be appropriate –

a. Where population is too small for a valid conclusion
b. When it is known there exists a high level of errors or systems failures or a possible fraud.
c. Where all the transactions in a population are material
d. Where data is required to be fully disclosed in the financial statements e.g directors' emoluments
e. Where the population is not homogeneous.
f. Where an auditor has been put on enquiry in any areas of the financial statements and/or company's operations
g. In unusual, one-off or extra-ordinary items.

3.2.3 Sampling Risk

This is the risk that the sample chosen may not be representative of the population as a whole. The auditor's conclusion based on the sample may be different from the conclusion he would reach if the entire population were subjected to the same audit procedure. There are two types of sampling risk:

a. the risk that the auditor will conclude, in the case of test of control, that control risk is lower than it actually is, or in the case of substantive test, that a material error does not exist when in fact it does. This type of error affects audit effectiveness and may lead to an inappropriate audit opinion and is known as Type 1 error.

b. the risk that the auditor will conclude, in the case of test of control, that control risk is higher than it actually is, or in the case of substantive test, that a material error exists when in fact it does not. This type of error affects audit efficiency as it may lead to additional audit work to establish that the initial conclusions were incorrect. This type of error is called Type II error.

A higher sampling risk increases audit risk as control and detection risks may be higher. The level of sampling risk the auditor is willing to accept affects the sample size. Lower risk acceptance level will imply bigger sample size.

Non-sampling Risk: Arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of sample, e.g. the auditor might use inappropriate substantive procedures or he might misinterpret evidence and fail to recognize an error. Non-sampling risk can be reduced by proper engagement planning, supervision and review.

3.2.4 Approaches to Selecting Samples

Two major approaches:

1. Non-Statistical or judgment sampling
2. Statistical sampling

1. **Non-Statistical or judgment sampling**: This involves selecting a sample of appropriate size based on the auditor's professional judgment of what is desirable.

Advantages:

1. The auditor can bring his judgment and expertise into play
2. No special knowledge of statistics is required
3. No time is spent in deciphering mathematical models
4. Well understood by auditors and refined by their experience based on years of use.

Disadvantages

1. Unscientific
2. Often sample sizes are too large, which can be wasteful, or too small, which renders the test invalid. Thus the sample size cannot be determined objectively
3. No consistency of result – two different auditors will produce two different results. Results cannot be evaluated objectively.
4. No quantitative results are obtained
5. Elements of personal bias in sample selection exist.
6. Sample selection may be skewed in favour of auditor's needs e.g items near year end are selected to assist in cut-off procedure.
7. No real logic to the selection of sample or its size.

This approach is scarcely used as it is too subjective to have any real validity.

2. **Statistical sampling:** Any approach to sampling that has the under-listed characteristics is statistical sampling:

a. random selection of a sample so that each sampling unit has a known chance of being selected
b. use of probability theory to evaluate results, including measurement of sampling risks.

Advantages:

1. It is scientific
2. It is defensible

3. It can be used by all levels of staff
4. It is efficient – just the correct sample size is selected, not too large, not too small.
5. Tends to result in a uniform standard of testing
6. Provides mathematical statements about probability of being correct.

Disadvantages

1. It is a mathematical process that requires skill and competence on the part of the user to be effective.
2. The principles of testing have to be applied properly in order for the tests to be valid.

3.2.5 Sample Design

In sample design, there is the need to consider:

1. The Population: The population from which the sample is to be drawn must be homogeneous. For example, suppose a company mid period replaced its invoice recording system, two population sets have arisen, the old and the new, from which samples have to be selected.

2. Level of Confidence: Any test of less than 100% of the population involves a certain degree of risk that the sample will not be truly representative of the population. This degree of risk is expressedin terms of confidence in the results e.g. 95% confidence level or 5% level of error means that there are 19 chances out of 20 that the sample is representative of the population.

3. Tolerable Error: This is the maximum error in a population that can be accepted for the audit objectives to be achieved. The tolerable error is related to and affected by:

- Materiality considerations
- Assessment of control risks
- Results of other audit procedures.

4. Expected Error: Level of error auditor might expect to find in the population. Sample sizes should be higher in populations with high expected error.

5. Anomalous Error: This is an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.

6. Materiality: This is a major consideration in fixing the sample size. Populations that are material to the overall audit opinion e,g debtors, stock, fixed assets must be sampled with smaller precision intervals and higher confidence levels.

3.2.6 Features of a Good Sample

In auditing, a sample should be:

a. Random – each item of the population has an equal (or specified) chance of being selected.
b. Representative – the sample should be representative of the items in the whole population e.g should contain similar proportion of high- and low-value items to the population.
c. Protective of the auditor – More intensive auditing should occur on high-value items known to be high risk.

d. Unpredictable – Client should not be able to know or guess which items will be examined.

3.2.7 Sampling Methods

Various sampling methods exist e.g. random, simple random, stratified sampling, systematic selection, multi-stage, block sampling, cluster sampling, Quota sampling, Value Weighted selection (Monetary unit method (MUS).The Nigerian standard recognizes the following principal methods of selecting samples:

- Use of computerized random number generator
- Systematic selection
- Haphazard selection and
- Block selection.

1. **Use of Computerized Random Number Generator**: All items in the population are assigned numbers. Numbers are then selected are then selected using computer generated random numbers. This method ensures items are chosen without bias.

2. **Systematic election**: The system involves making a random start and then taking every nth item thereafter. The sampling interval is fixed by dividing the population by the sample size. E.G if the population is 1000 and sample size is 20, the sampling interval will be every 50^{th} item.

3. **Haphazard Selection**: Here the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor tries to avoid any conscious bias or predictability (e.g. avoiding difficult to locate items or 1^{st} or last entries on a page) and thus attempts to ensure that all items have a chance of selection. Not appropriate when using statistical sampling.

4. **Block Sampling**: This involves choosing at random one block of contiguous items or transactions in a population e.g. March credit sales. This method is rarely recommended because of its defects.

Self-assessment question

1. Explain the factors you will consider in sample design.
2. State the advantages of statistical sampling.
3. Explain the following sampling methods:
   a) Weighted value selection
   b) Systematic selection
   c) Haphazard selection

3.3 ANALYTICAL PROCEDURES (ISA 520/NSA 17)

Analytical Procedures: Defined as the evaluation of financial information made by a study of the plausible relationships between elements of financial information expected to conform to a predictable pattern and between financial information and non-financial information. Information is compared with comparable information for a period or periods, with anticipated results and

with information relating to similar organizations. It involves the breaking down of data into subdivisions for analysis over time, by product, by location, by management responsibility etc.
In the application of analytical procedures:

- Unexpected variations/deviations are identified and explanations for such deviations are obtained and substantiated.
- Results of an analytical review are evaluated with other audit evidence obtained.

In the use of analytical procedures

- Trends and ratios are employed and watched
- Comparisons with previous periods are made and explanations sought
- Comparisons with forecast and budgets are made and analysed
- Increases in magnitude corresponding to inflation or in excess of inflation are considered and
- Inter-firm comparisons are made and explanations sought.

3.3.1 Reasons for Performing Analytical Procedures

The reasons for carrying out analytical reviews include:

1. Analytical procedures can help the auditor to develop an understanding of the entity, and highlight matters of which the auditor was previously unaware. Procedures are therefore invaluable in terms of developing knowledge about the operations and performance of the entity. For example, this may be particularly important in the case of a new audit client, when analytical procedures such as a comparison of margins made by the entity with those made by its competitors will provide the auditor with some degree of knowledge about the relative performance of the entity within its business environment.
2. Performing analytical procedures at the planning stage may indicate aspects of the financial statements which appear to carry a high risk of material misstatement. This would happen when unexpected trends and unusual relationships between pieces of financial data were revealed by the analytical procedures. For example, procedures may reveal that revenue has increased by say, 25% compared to the previous year, but that the budgeted increase was only 10% and the industry average increase was only 8%. These results could indicate the possible overstatement of revenue, and thus the auditor has been alerted to a possible material misstatement in the financial statements.
3. Performing analytical procedures can help the auditor to prioritise identified potential areas of risk, and to develop an appropriate audit strategy to minimise detection risk.
4. It helps to determine the extent of substantive tests that will be required based on the assessed risks.
5. It helps to identify areas that require further audit investigation
6. To corroborate conclusions formed during the audit
7. To assist the auditor in carrying out an overall review of the financial information.

3.3.2 Types of Analytical Procedures

1. Trend Analysis: This involves analysis of changes in an account balance or ratio over time. Trend analysis gives good results when the account or relationship is fairly stable but less effective when the audited entity has experienced significant operating or accounting changes. The number of years to employ in trend analysis is a function of the stability of operations. The more stable the operations over time, the more predictable the relations and the more appropriate the use of multiple time periods. More precise results are got when trend analysis is applied to disaggregated data than on aggregate data (e.g analysis by segment, product, location, monthly rather than annually etc).

2. Ratio Analysis: This involves the comparison of elements of financial statements, the comparison of an account with non-financial data (e.g. payroll cost with number of employees), or the comparison of relationships between firms in an industry. In analytical procedures, five types/groups of ratios are in common use:

a. ratios that compare client and industry data e.g. industry averages published rating agencies or Trade associations of Bureau of statistics.

b. ratios that compare client data with similar prior period data e.g. current year account balances and ratios with those of preceding year.

c. ratios that compare client data with client determined expected results e.g actual performance against budgets.

d. ratios that compare client data with auditor-determined expected results e.g. recorded interest cost compared with auditor computed expected interest balance.

e. ratios that compare client data with expected results using non-financial data e.g. multiplying room rate by number of rooms by average occupancy rate can give an estimate of a period revenue of a hotel.

3. Reasonableness Testing: This is the analysis of account balances or changes in account balances within an accounting period in terms of their "reasonableness" in light of expected relationships between accounts. Reasonableness tests use information (economic, industry etc) to develop an explicit prediction of an account balance. For example, the auditor could use number of units sold, the unit price by product line, different pricing structures and factoring in industry trends within the period, to come up with a reasonableness test for sales within a period.

4. Data Mining: This involves using CAATs to examine large volumes of data with the objective of indicating hidden or unexpected information or patterns. Data mining is referred to as knowledge discovery in databases (KDD). Data to be mined can be numerical, textual or even graphics and audio. Data mining is used to verify auditor's expectations or explain events or conditions observed. E.g. Purchase orders and delivery dates are examined to see if the delivery date falls after the order date.

3.3.4 STAGES IN AUDIT WHEN ANALYTICAL PROCEDURES ARE APLLIED

1. At the audit planning stage – as a risk assessment procedure to obtain an understanding of the entity and its environment.

2. During the audit – as substantive procedures in reducing risk of material misstatement at the assertion level. It is employed as a means of gathering audit evidence.

3. At the final review stage of the audit – to provide support for the conclusions arrived at as a result of other works. It is also used to assess the overall reasonableness of the financial statements as a whole.

Factors that influence the extent of use of analytical procedures in the conduct of an audit include:

1. The nature of the entity and its operations: Is the organization a long established company with old manual systems or a new one with cutting-edge technology? A good level of ICT adoption and application act as incentive in the use of analytical procedures.
2. Availability or non-availability of nonfinancial information to support financial information e.g .production statistics, input mixes, labour hours worked etc
3. Knowledge gained in the previous audit of the enterprise – will give indication on areas of greatest audit risk or where errors and difficulties arose etc
4. The reliability, relevance and comparability of the information available in the client company. Does client take part in inter-firm comparison exercises? If yes, it is appropriate for analytical review evidence.
5. The cost effectiveness of the use of analytical procedures in relation to other forms of evidence. Some analytical procedures, especially those involving the use of complex statistical techniques (e.g using multiple regression to estimate the sales for a period using economic and industry data) and computer audit software require experienced and specialized staff and may be expensive.
6. Management's own use of analytical procedures e.g. reliable budgetary control system.

3.3.5 Steps in Performing Analytical Procedures

Four steps are involved in the process namely:

1. Expectation: Develop an expectation of an account (or ratio) balance. Information available to the auditor to develop expectations for analytical procedures include:
    - ❖ Financial information for comparable prior periods
    - ❖ Anticipated results such as budgets and forecasts
    - ❖ Relationships among elements of financial information within a period
    - ❖ Information derived from similar firms in the same industry such as industry averages
    - ❖ Relationships between financial information and relevant nonfinancial information
2. Identification: Identify and compare the amount of difference from the expectation that can be accepted without investigation. The amount of difference that can be accepted without investigation is determined primarily by the amount considered to be a material misstatement by the auditor.
3. Investigation: Investigate possible explanations for material differences between expected and recorded values. The greater the precision of the expectation, the more likely the

difference between the auditor's expectations and recorded values will be due to misstatements..

4. Evaluation: Evaluate the impact on the financial statements of the difference between the auditor's expected value and the recorded value. Inquiries of management are essential and their explanations will need to be corroborated with other audit evidence. ILLUSTRATION

You are the audit Manager of your Firm. You are planning the audit of UP-TO-DATE SYSTEMS LTD, a company that develops and licenses specialist computer software and hardware. The company's non-current assets mainly consist of property, computer hardware and investments, and there have been additions to these during the year. The company is experiencing increasing competition from rival companies, most of which specialize in either hardware or software but not both. There is pressure to advertise and cut prices.

You have been provided with the draft income statement below for your preliminary assessment.

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2015.

	2015	**2014**
	₦'000	**₦'000**
Sales	15,206	13,524
Cost of sales	(3,009)	(3,007)
Gross profit	12,197	10,517
Distribution costs	3,006	1,996
Selling expenses	3,002	274
Administrative expenses	994	1,768
	7,002	4,038
Profit from operations	**5,195**	**6,479**
Net interest receivable	995	395
Profit before Tax	**6,190**	**6,874**
Company tax	(3,104)	(1,452)
Profit after tax	**3,086**	**5,422**
Dividends paid	(1,469)	(1,439)
RETAINED PROFITS	1,617	3,983
Earnings Per Share	**43 kobo**	**104 kobo**

As part of your risk assessment procedures for UP-TO-DATE SYSTEMS LTD, comment on the performance of the company for the two years and from your comments identify areas of audit emphasis for the year 2015.

Suggested Solution

1 **UP-TO-DATE SYSTEMS**

FINANCIAL ANALYSIS, COMMENTS AND AREAS OF AUDIT EMPASIS – 2015 AUDIT

	2015	**2014**	**%CHANGE**
PERFORMANCE RATIOS:			
Growth in sales (Naira increase/2014 sales)	12%	-	+12%
Increase in COGS (Naira incr./2014 fig.)	0.07%	-	-0.07%
Gross margin (GP/SALES)	80%	78%	+ 2.56%
Operating profit ratio (operating profit/Sales)	34%	48%	-29.16%
Profit before tax ratio (PBT/Sales)	41%	51%	- 19.61%
Growth in Investment Income	152%	-	+152%
Expenses as percentage of sales (Expense/Sales):			
Distribution cost	20%	15%	-33.33%
Selling expense	20%	2%	-900%
Administrative expenses	7%	13%	+46.15%
EPS (Given)	43k	104k	- 58.65%

*Possible increase in Equity Capital ₦1.96m (assuming shares of ₦1 each)

*Possible increase in Share Capital is got as follows:

EPS = PAT/no. of Ord. shares

Let X = no. of Ord. shares;

Then, Shares in issue as at 31 Dec. 2014 = 5,422,000/1.04 = 5,213,462 shares.

Shares in issue as at 31 Dec. 2015 = 3086000/.43 = 7,176,744 shares.

Increase in no. of shares: 7,176,744 – 5,213,463 = 1,963,281 shares of =N=1 each.

COMMENTS

- **G**rowth in turnover of about 12% but a marginal increase in gross margin from 78% in 2014 to 80% in 2015. Indicates that, thus far, there has not been material change in pricing policy and no cut-off problem.

- ❖ Almost a zero percent increase in cost of sales is recorded. Suppression of some costs is suspected as costs are expected to rise in sympathy with sales.
- ❖ Operating profit ratio fell from 48% in 2014 to about 34% in 2015. High operating cost is implicated.
- ❖ Analysis of expenses indicates a rise from 15 kobo per naira sales in 2015 to 20 kobo in 2015, for distribution expenses and a rise from 2 kobo per naira sales in 2014 to about 20 kobo per naira in 2015, for selling expenses. A decline of 46.15% is reported in administrative expenses. Again, there is a possibility of costs suppression in order to achieve a particular performance target or to cover up the high rise in selling expenses.
- ❖ From EPS ratio, capital injection of about ₦2million is indicated. This did not reflect in operating profits as it appears to have been channeled to investments.
- ❖ A growth in investment income of about 152% is recorded. In spite of this, Earnings Before tax still fell from about 51% to about 41% in 2015.
- ❖ Thus, the fresh capital injection neither magnified sales nor earnings for Equity holders, as EPS fell from 1.04 in 2014 to 0.43 in 2015.

AREAS OF AUDIT EMPHASIS

1. The following overhead costs should be disaggregated and investigated:

- ❖ Cost of sales
- ❖ Distribution expenses
- ❖ Selling expenses and
- ❖ Admin. expenses

2. Additions to investments and fixed assets will need to be examined and validated.

3. Company tax should be investigated and re-computation done if necessary.

4.0 Conclusion

Compliance tests and substantive tests are the two forms of audit tests. Because all items cannot be tested during an audit, samples are usually taken to represent the generality of the transactions, on the basis of which conclusions are drawn. Analytical procedures are widely employed in audits, first as a risk assessment procedure at the planning stage of the audit, as substantive procedures in reducing risk of material misstatement at the assertion level during the audit and at the final review stage of the audit to provide support for the conclusions arrived at as a result of other works.

5.0 Summary

In this unit we have examined the forms of audit tests, the requirements of ISA 530 *Audit sampling and other means of testing* as well as the requirements of ISA 520 *Analytical Procedures*. This unit finally gave an illustration of the use of analytical procedures as a risk assessment procedure.

6.0 Tutor-marked assignment

1. Maybros Fashion Shops Plcown a chain of shops in major towns in South-East, Nigeria. Each shop is operated by a separate subsidiary company. All subsidiaries buy from the parent. The Auditors of Maylux shop are reviewing the accounts for the year ending 31 December 2011 before starting the audit.

These reveal (in extract):

	2010	2011	Budget 2012
	₦'000	**₦'000**	**₦'000**
Turnover	6,000	6,380	6,400
Cost of sales	4,000	4,590	4,250
Gross profit	2,000	1,790	2,150
Wages	780	710	700
Overheads	700	750	740
Net Profit	520	330	710
Stock	580	530	620
Creditors	710	790	740

External data known to the auditors include:

1. Rate of inflation 5%
2. A university survey, found on the internet, of the traders in the area in which the shop is situated indicates a 5% growth in real terms.
3. The rate of gross profit achieved by other shops in the group was 345% and average stock was 45 days' worth.
4. Creditor days in three other shops averaged 65 days.
5. Wages in the other shops averaged 13% of turnover.

From the above information, and using analytical procedures, highlight areas of audit emphasis in Maylux shop for the year 2011.

2. **(a)** ISA 520 *Analytical Procedures* requires that the auditor performs analytical procedures during the initial risk assessment stage of the audit. These procedures, also known as preliminary analytical review, are usually performed before the year end, as part of the planning of the final audit.

Required:

Explain the reasons for performing analytical procedures as part of risk assessment procedures.

(b) Belzy Fashion Shops Plc owns a chain of shops in major towns in South-East, Nigeria. Each shop is operated by a separate subsidiary company. All subsidiaries buy from the parent. The

Auditors of Benarc shop, a subsidiary of Belzy, are reviewing the accounts for the year ending 31 December 2011 before starting the audit and have computed some ratios in their analytical review exercise.

Required:

Explain the possible reasons for the following changes found at the planning stage of the audit:
i. A decrease in gross profit percentage
ii. An increase in the inventory holding period
iii An increase in the current ratio
iv. an increase in dividend cover
v. An increase in capital gearing

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST

2. International Standards on Auditing 520 and 530.

3. Whittington &Pany (Current edition).Principles of Auditing and Other Assurance Services. New York: Mcgraw-Hill/Irwin

Unit 11: AUDIT EVIDENCE AND USING THE WORK OF AN EXPERT

Content

1.0 Introduction

In this we discuss the nature of audit evidence, its sources, qualities and persuasiveness (ISA 500) and the use of the work of the auditor's expert (ISA620) as a source of evidence. The unit further examines the requirements of ISA 610 *Reliance on internal auditor's work,* ISA 540 *Audit of accounting estimates* and ISA550/IAS 24 *Related Party transactions*and highlights the nature of the evidence needed in these cases.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain audit evidence and state the sources of audit evidence
- Define auditor's expert and discuss the factors that may influence auditor's reliance on the work of an expert.
- Explain the factors that may affect the external auditor's decision to use the work of the internal audit function
- Discuss related party relationships and transactions and their audit risk implications.
- Discuss areas that need estimates and judgments by management and the audit risk implications of accounting estimates.
- Evaluation the competence of written representations as audit evidence.

3.0 Main Content

3.1 Audit Evidence (ISA 500)

Concept/Nature

ISA 500 requires the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusion on which to base the audit opinion.

Audit evidence *is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes all the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to address all the information that may exist.*

Thus audit evidence

- is any information that corroborates or refutes an assertion.
- It is obtained during a financial audit and recorded in the audit working papers.
- It varies in the extent to which it persuades the auditor (i.e. the degree of comfort the evidence provides) in enabling him form his opinion on the accounts under audit.

Relationship between key variables in the Standard

a. Sufficiency and Appropriateness of Audit Evidence influence Quality of Audit Opinion expressed and

b. Adequacy of Audit Procedures adopted influences the Quality of Audit Evidence obtained. Thus inadequate Audit Procedure leads to insufficient and inappropriate Audit evidence which translates to unreliable Audit Opinion and high audit risk as users may misjudge client's financial health

Factors Affecting Persuasiveness or Quality of Audit Evidence

The standard requires "Sufficient, Appropriate Evidence"

Sufficiency is the measure of the amount/quantity of Audit Evidence while *appropriateness* is the measure of the Quality of Audit Evidence, that is, its relevance and its reliability in providing support for or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

Quantity of Audit evidence needed is affected by the assessment of risk of material misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less the audit evidence that may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate if it is of a lower quality.

Some Helpful Questions for Assessing Quality of Audit Evidence

- Is provider independent of entity (e.g. external or internal)?

- Even if provider is independent, what are the qualifications of the provider?
- Is client's Internal Control Structure strong, weak or somewhere in the middle?
- Did you obtain the evidence directly (e.g. by your own computation or through your own observation) or is it client provided?
- What is the degree of subjectivity of the evidence (eg a bank balance versus and attorney's letter discussing anticipated success in an upcoming trial)?

Competence of Evidential Matter

To be Competent evidence must be:

Relevant – Must relate to the audit objective.

Sufficient – Must be such number of evidence that is statistically significant for the auditor to form independent and unbiased opinion.

Reliable and Valid – Independent sources have greater reliability than those within the client organization

Note:

1. An audit evidence is *appropriate* if it assists the auditor in forming an opinion on assertions on which the financial statement is based.
2. In relation to *reliability:*
   - Strong Internal Control increases reliability of evidence created within the client organization.
   - Evidence obtained from independent sources outside the entity under audit is more reliable
   - Directly obtained evidence (that is originated by the auditor by means of analysis, inspection, audit testing etc) is more reliable than evidence obtained second hand.
   - Documentary evidence is more reliable than oral evidence.
   - The cumulative effect of several evidential sources which give a consistent view is greater than that from a single source (2 + 2 > 4).
   - Original documents are more reliable that photocopies.

3. Sufficiency is a matter of the auditor's judgment but usually influenced by the auditor's knowledge of the business and its industry and the degree of assessed audit risk.

Types of Audit Evidence

	Type	Description	Example
1	Physical Examination	Inspection of tangible asset: Does asset exist? (Evidence that can actually be seen by the auditor).	Inspecting/counting inventory or cash. Is generally effective for supporting the existence assertion.

2	Confirmation (3rd Party Representation)	Written or Oral response from 3rd party.	Sending positive confirmation to account receivable customers, Lawyers' letters, Report of specialists.
3	External and Internal Documentation	Examining Client's documents and records from within & outside the client's organization (Vouching).	Examining shipping document to support a sale
4	Re-performance (Computation)	Rechecking computations or transfers of information -tracing. Performed independently by auditors. Used to verify mathematical accuracy of client's analyses and records.	Checking Depreciation calculation or tracing from sales journal to general ledger
5	Observation	Observing activity or facility	Touring plant; observing payroll check distribution
6	Analytical Procedures (Data Interrelationship)	Making comparisons to judge reasonableness of certain account balances	Comparing Cost of Goods sold or Gross margin to sales revenue over several periods.
7	Inquiries of Client (Client Representations)	Asking questions (oral or written response) of client. Responses to questions and inquiries to clients during an audit constitute audit evidence.	Your systems project where you asked how client recorded a sale, filled out a purchase order, etc in order to prepare a systems flowchart.

3.2 USING THE WORK OF AN EXPERT (ISA 620/NSA 27)

In some audits, the auditor's knowledge may be insufficient in a particular field to enable him generate sufficient appropriate audit evidence to substantiate his opinion. In such circumstances, he may need to rely on the opinions of experts or specialists to help him form an opinion.

ISA 620/NSA 27, *Using the work of an Expert,* states: *When using the work of an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.* This implies that the auditor has the responsibility to confirm whether the work performed by the expert is adequate for the purpose of the audit.

Definition: An expert is defined by the standard as 'a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

The auditor usually relies on the work of such experts as:
1. *Valuers* – for the valuation of certain assets e.g Land and Building, Plant and Machinery, works of Arts and precious stones or jewelry.
2. *Geologists* – for the determination of quantity and quality of mineral and petroleum reserves.
3. *Actuaries* – for valuation of pension schemes liabilities
4. *Quantity Surveyors* – for determination of work done on long-term contracts in progress.
5. *Stockbrokers* – on the value of securities
6. *Lawyers* – for legal opinions concerning interpretation of agreements, statutes and regulations, etc.

An expert may be:
a. contracted/engaged by the client entity
b. contracted/engaged by the auditor
c. employed by the entity or
d. employed by the auditor.

3.2.1 Points for Consideration when deciding to use the work of an Expert.

In deciding on whether to use the work of an expert during an engagement, the auditor will consider:
1. The knowledge and abilities of the audit team: If the team members do not have the expertise and experience to deal with issue, an expert may need to be called in.
2. The risk of material misstatement based on the nature, complexity and materiality of the matter being considered.
3. The quantity and quality of other audit evidence which can be obtained (alternative sources of evidence). In some cases, the auditor may have little other evidence except the expert's opinion e.g estimation of petroleum reserves.

The standard advises that when planning the use of the work of an expert, the auditor should evaluate the professional competence and objectivity of the expert. Thus, *factors which may influence the reliance* of the auditor on the work of a specialist include:

i). *The Competence of the specialist*: This may be indicated by technical and professional certification and licensing by or membership of an appropriate professional body and reputation in the field in which the auditor is seeking audit evidence.

ii). *The experience of the specialist:* The expert needs to have the appropriate experience to carry out the job, however well-qualified technically/professionally that person may be. Reference to or personal experience with previous work of the expert is important.

iii). *The independence of the expert*: The independence of the expert will guarantee his objectivity. The risk that an expert's objectivity will be impaired increases when the expert is an employee of the client entity or is related to the directors or employees of the entity or has financial interest (other than his fees) with the client.

iv) *Scope of the expert's work*: The auditor should obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purpose of the audit. This may require consultation between client, auditor and the expert at the time the specialist is appointed to agree on the work to be performed. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used. In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement.

The instructions to the expert should therefore cover:

- ❖ The objectives, scope and subject matter of the expert's work.
- ❖ The intended use by the auditor of the expert's work including the possible communication to third parties of the expert's identity and extent of involvement.
- ❖ The extent of the expert's access to appropriate records and files.
- ❖ Clarification of expert's relationship with the entity if any.
- ❖ Sources of information to be provided to the expert
- ❖ Confidentiality of the entity's information
- ❖ Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods.

Where these matters are not clearly defined in the expert's terms of reference, the auditor may need to communicate with the expert directly to obtain audit evidence in this regard.

v) *Evaluation of the work of the Expert/Relevance of Conclusions*: Though the auditor does not have the same level of expertise and experience as an expert, it is his responsibility to decide whether the work of the expert provides sufficient appropriate evidence for the purpose of the audit. The auditor, therefore, will need to review the findings of the expert and draw his own conclusions. He will look at:

a). the source of data on which the expert based his opinion.

b).the assumptions and methods used by the expert and their consistency with prior periods, if any.

c). results of the expert's work in the light of the auditor's overall knowledge of the business and the industry and the results of other audit procedures that may corroborate the expert's opinion.

The auditor may further want to review the sources of data to ascertain their reliability, review the specialist's procedures and reviewing or testing any data used by the expert in order to satisfy himself that the expert's work can be relied upon.

If the results of the expert's work do not provide sufficient appropriate audit evidence or not consistent with other audit evidence, the auditor may:

- engage another expert (cost consideration is important here).
- Apply additional procedures
- Discuss with client and expert for possible resolution of difficulties or
- Modify the auditor's report as a last resort.

3.3 Reliance on the work of the internal Auditor (ISA 610)

Reliance on internal audit

The work of the external auditors and internal auditors may overlap in the area of financial audits. In such a case, the external auditors may decide to rely on work already carried out by the internal auditors and reduce the amount of testing and checking they carry out for the external audit.

However, the external auditor is responsible for his opinion on the financial statements, even if he has relied on the work of others such as internal auditors and external experts. He must therefore satisfyhimself that the internal auditor's work can support his audit opinion.

3.3.1 ISA 610: Using the work of internal auditors

Where the external auditor has decided to use the work of the entity's internal audit function, ISA 610 directs that the external auditor will need to evaluate the internal audit function and its procedures.

The following factors should be considered by the external auditor in making the assessment of internal audit:

i. The status of the internal audit department within the entity: In particular, the objectivity andthe operational independence of the internal audit department is important. It is also necessary to note whether there are restrictions placed by senior management on the scope of the internal audit work and whether management act on internal audit reports and recommendations. This helps to take decision on the effectiveness of the internal control.

ii. The technical competence and due professional care of the internal auditors. The external auditors must be satisfied that the internal audit staff have sufficient technical competence and take a professional approach towards their work.

iii. Regular and effective communication and meetings between the external and internal auditors at appropriate intervals on any significant matters that might affect the other's work, is important.

To determine the planned effect of the work of internal audit on the nature, timing and extent of the external auditor's procedures, the external auditor is required to consider:

a. the nature and scope of specific work performed or to be performed by internal audit
b. the assessed risks of material misstatement at the account balance/transaction level
c. the degree of subjectivity involved in the evaluation of evidence gathered by internal audit.

Before using specific work of internal audit, the external auditor is required to evaluate whether:

- the work was performed by internal auditors with adequate technical training and proficiency
- the work was properly supervised, reviewed and documented
- adequate audit evidence was obtained
- appropriate conclusions were reached, consistent with any reports prepared
- any exceptions or unusual matters were properly resolved.

Procedures to achieve this might include:

a. examining items already examined by internal audit
b. examining other similar items
c. observing procedures performed by internal audit.

The external auditor's evaluation of the internal audit function and its work should be fully documented in the external auditor's working papers.

Self-assessment questions

1. What are the factors the auditor should consider before deciding to use the work of the internal audit function.

3.4 Audit of Accounting Estimates (ISA 540)

3.4.1 The nature of accounting estimates and the audit problem

In the preparation and presentation of financial statements, management has the responsibility make estimates and judgments that are reasonable in situations where it is not practical or not possible to obtain a more precise measurement of an item. ISA 540 defines an accounting estimate as ‘an approximation of a monetary amount in the absence of a precise means of measurement.’

Examples of areas where estimates are widely used include

- Accruals and prepayments,
- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Costs arising from litigation settlements and judgments
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability
- Outcome of long-term contracts
- fair values,
- deferred tax

Additional examples of situations where fair value accounting estimates may be required include:

- complex financial instruments, which are not traded in an active and open market
- share-based payments
- property or equipment held for disposal
- certain assets or liabilities acquired in a business combination, including goodwill and intangible assets
- transactions involving the exchange of assets or liabilities.

Audit evidence relating to such estimates is often of relatively poor quality because of the nature of the items involved. As a result, the audit risk in this area can be high.

3.4.2 ISA 540: Auditing accounting estimates - auditing procedures

ISA 540 requires auditors to obtain sufficient appropriate audit evidence as to whether accounting estimates (whether recognised or disclosed in the financial statements) are reasonable, and whether the related disclosures are adequate.

ISA 540 (revised) calls for greater rigour and scepticism in the audit of accounting estimates.A risk based approach, which focuses on those estimates that have high estimation uncertainty, is recommended.

The following procedures are recommended:

As part of his risk assessment procedures, the auditor should obtain an understanding of the following.

- The requirements of the applicable financial reporting framework (for example, international accounting standards) in respect of accounting estimates, including related disclosures.
- How management identify transactions or events that could result in an accounting estimate being recognised or disclosed in the financial statements.
- The nature of the estimates for example, obtaining an understanding of the obligation for which an estimate is needed in the case of a liability.
- The auditor should also review the procedures used by management to make their estimates, including:
    - the method used for estimating (for example in deciding the estimated useful lives of non-current assets)
    - relevant controls
    - the use of experts
    - the underlying assumptions
    - whether there ought to have been any change in the method used since the prior period
    - whether and how management has assessed the effect of estimation uncertainty.
- If possible, the auditor should check the amount of an estimate against other known facts, to assess whether the estimated amount seems reasonable.

The auditor should also:

- review the outcome of accounting estimates included in the previous period's financial statements (to assess their reliability) and consider changes in the estimate from one year-end to the next
- evaluate the degree of estimation uncertainty associated with each current period estimate and, if the risk is high, whether this gives rise to significant risks.

The above procedures enable the auditor determine whether management has properly applied the requirements of the applicable financial reporting framework, and whether the methods used for making the estimates are appropriate and have been consistently applied.

In response to the assessed risks of material misstatement the auditor must then perform one or more of the following procedures:

- Determine, through a review of events after the reporting date, whether events up to the date of the auditor's report provide sufficient audit evidence in respect of the validity of the estimates.
- Test how management made the estimate and the data on which it is based, considering the method used and assumptions made.
- Test the controls over management's procedures for making estimates and carry out appropriate substantive procedures.

- Develop his own estimate or range of estimates and compare to management's figure, evaluating any significant differences.

The auditor is also required to consider the need for expert evidence, obtain written representations from management, and document the basis for his conclusions and any indications of management bias.

ISA 540 provides the following examples of indicators of possible management bias in estimates:

- Changes in an accounting estimate, or the method for making it, where this is a subjective assessment.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield an estimate which favours management objectives.
- Selection of an unduly optimistic or pessimistic estimate.

3.4.3 Auditing fair value measurements

Balances of items measured at fair value, such as property and financial instruments, are often significant items in the statement of financial position, and thus translate to significant audit risk.

The auditor needs to recognise the audit risk in fair value measurements:

Inherent risk: Many fair value measurements are largely subjective and imprecise, and there is unavoidable inherent risk in their measurement. The inherent risk is much less when an open market exists for the items measured at fair value.

Control risk: Fair value measurements are often made by external experts, outside the normal course of routine business operations, and the controls over the valuation process are therefore likely to be weak.

Detection risk: The auditor may lack the knowledge and expertise to verify fair value measurements forcing him to rely on the work of an external expert. This increases the risk that errors in fair value measurements will not be discovered.

Self-assessment questions

1. Discuss required auditor's procedures in the audit of accounting estimates.

3.5 Related Parties (ISA 550 and IAS 24)

Related parties are individuals or organisations that might have, or might be expected to have, an undue influence on the company that is being audited.

According to ISA 550, related party is a party that is either:

a) A related party as defined in the applicable financial reporting framework; or
b) Where the applicable financial reporting framework establishes minimal or no related party requirements:
    - A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
    - Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
    - Another entity that is under common control with the reporting entity through having common controlling ownership, owners who are close family members; or common key management.

Examples of related parties include the directors and key management of a company, their families, other companies controlled by directors, key managers and members of their close family and other companies in the same group.

. It is the responsibility of management to identify,record and disclose all material related party transactions, because these transactions may be carried out on more favourable terms than similar transactions with an independent third party.

IAS 24 *Related party disclosures* requires that the relevant amounts of related party transactions and the nature of the related party relationships, should be disclosed.

3.5.1 The impact on the audit of related party relationships and transactions

ISA 550 *Related parties* deals with the auditor's responsibilities in respect of related party transactions.

In some circumstances related party transactions may lead to higher risks as the audit may not detect all material related party transactions. This is usually the case when:

- Related party transactions have taken place without charge or not conducted on normal market terms
- Related party transactions are not self-evident to the auditors
- related parties operate through complex structures and relationships and the resulting transactions may therefore also be complex
- accounting systems may not be effective at identifying and summarising related party transactions and balances
- active steps have been taken by management to conceal either the full terms of a transaction, or that a transaction is, in substance with a related party.

The objectives of the auditor with regard to ISA 550 are to obtain:

i. an understanding of the entity's related party relationships and transactions, and

ii. sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements.

The understanding must be sufficient for the auditor to be able to:

- recognise fraud risk factors arising from related party relationships and transactions
- conclude whether the financial statements achieve fair presentation in respect of related party relationships and transactions.

The risk of fraud in this area is high as related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

3.5.2 Risk Assessment Procedures

As part of the risk assessment procedures required by ISAs 240 and 315 the auditor is required to perform the following procedures in order to understand the entity's related party relationships and transactions:

i. Consider the risk of material misstatement due to fraud or error arising from related party relationships and transactions.
ii. Make inquiries of management in respect of the identity of related parties, the nature of relationships with those related parties and the nature of any transactions entered into with those parties during the period.
iii. Obtain an understanding of the internal controls in operation over the identification of, accounting for and disclosure of related party relationships and transactions; the authorisation and approval of significant related party transactions; and the authorisation and approval of significant transactions outside the normal course of business.

Identifying related parties and related party transactions

In making inquiries of management in respect of the identity of related parties, the auditor will obtain a list of related parties from the directors, and consider if this list is complete.

Tests for completeness could include the following:

i. Review working papers for previous years, to look for names of known related parties.
ii. Review the company's procedures for identifying related parties.
iii. Inquire about the relationships between directors and other entities (for example, director's ownership of a company that transacts business withthe client company)
iv. Review shareholder records for the names of major shareholders.
v. Review minutes of shareholder meetings (general meetings of the company).
vi. Ask any other audit firms involved in the audit about related parties (if the audit is the audit of a group of companies and more than one firm of auditors is involved). Or ask previous auditors of the company about their knowledge of related parties.

Note: Two companies are not necessarily related parties just because the same individual is a director or shareholder in both. The key issue is whether the individual is in a position of influence in both companies. .

If any fraud risk factors are found these must be taken into account when the auditor identifies and assesses the risks of material misstatement due to fraud in accordance with ISA 240. A key fraud risk factor identified by ISA 550 is the existence of a party who exerts dominant influence over the entity.

Indicators that a person or entity might be a dominant party include:

- the party vetoing significant business decisions of the entity
- significant transactions being referred to the party for final approval
- little or no debate among management in respect of business proposals made by the party
- transactions involving the party (or its close family members) are rarely independently reviewed or approved.

Responses to the risks of material misstatement

If the auditor discovers previously unidentified or undisclosed related parties or (significant) related party transactions he must:

a. Determine whether the underlying circumstances confirm the existence of those relationships or transactions.
b. Communicate the relevant information to the audit team.
c. Request management to identify all transactions with the newly identified related parties.
d. Inquire as to why the entity's system failed to identify or disclose these related party relationships or transactions.
e. Perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
f. Reconsider the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and perform additional procedures as necessary.
g. If the non-disclosure appears intentional, evaluate the implications for the audit

If the auditor discovers significant related party transactions outside the entity's normal course of business he must:

a. Inspect the underlying contracts or agreements to evaluate whether:
    - the contracts etc. were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets
    - the terms of the contracts etc. are consistent with management's explanations, and
    - the transactions have been properly accounted for and disclosed.
b. Obtain evidence that the transactions were properly authorised.

If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm's length transaction, the auditor must obtain evidence to support this assertion.

Materiality of related party transactions

Most related party transactions, notwithstanding the size of the transactions in monetary terms may be material as the significance of the transaction to the users of the financial statements may not depend solely on the value of the transaction but also on the nature of the related party relationship.

Other requirements

Written representations must always be obtained by the auditor from the directors about related parties and related party transactions, as tothe completeness of the information that has been provided about the identity of related parties and related party relationships and transactions, and the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

Self-assessment questions

1. Explain related party transactions and why such transactions constitute significant audit risks.

2. Discuss the procedures an auditor needs to perform in order to understand the entity's related party relationships and transactions.

3.6 Written Representations (ISA 580)

3.6.1 Definition and objectives

A written representation, according to ISA 580, is a written statement by management provided to confirm certain matters or to support other audit evidence.

The objectives of the auditor in this area, per ISA 580, are:

a) To obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
b) To obtain written representations as appropriate to support other audit evidence
c) To respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

3.6.2 Written representations as audit evidence

During the course of an audit, management make many verbal representations to the auditor, either in response to specific inquiries from the auditor or voluntarily. The auditor asks for any such significant discussions to be confirmed in writing in order to improve the quality of the evidence.

However, although such written representations provide necessary audit evidence, they do not provide sufficient appropriate evidence on their own.

If a written representation is contradicted by other audit evidence, the auditor should:

- consider whether his risk assessment of that area is still appropriate
- consider whether additional audit procedures are needed
- if he has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

3.6.3 Written representations about management's responsibilities

The auditor is also required by ISA 580 to obtain certain other written representations from management in which management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information and
- all transactions have been recorded and are reflected in the financial statements.

3.6.4 Other written representations

The auditor may require some other written representations beyond the requirements of ISA 580, either to support other audit evidence relevant to the financial statements or some assertions in the financial statements. Examples include issues like

- whether the selection of accounting policies are appropriate
- whether the following matters have been recognized, measured, presented or disclosed correctly – plans or intentions affecting values of assets, liabilities, title to or control over assets, aspects of laws and regulations that may affect the financial statements etc
- whether all deficiencies of internal controls have been communicated to the auditor.

The following ISAs require specific written representations:

- ISA 240 The auditor's responsibility to consider fraud in an audit of financial statements
- ISA 250 Consideration of laws and regulations in an audit of financial statements
- ISA 450 Evaluation of misstatements identified during the audit.
- ISA 501 Audit evidence – additional considerations for specific items
- ISA 540 Auditing of Accounting estimates, including fair value accounting estimates and related disclosures.
- ISA 550 Related Parties
- ISA 560 Subsequent events
- ISA 570 Going Concern
- ISA 710 Comparatives.

Note: The letter of representation is usually drafted by the auditor (as he knows the areas on which he requires written representations), addressed to the auditor and dated as near as practicable (but not after) the date of the audit report. The letter is signed by the CEO and the CFO.

3.6.5 Refusal to provide requested written representations

If management refuse to provide requested written representations the auditor must discuss the matter with management, re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence, and take appropriate action, including considering the effect on the audit report.

3.6.6 Doubt about the reliability of written representations

Where written representations are inconsistent with other evidence and the matter cannot be resolved through audit procedures, the auditor need to reconsider his assessment of the competence, integrity and ethical values or diligence of management and the effect this may have on the reliability of representations and audit evidence in general.

Where the auditor concludes that written representations are not reliable, he should take appropriate actions, including determining the impact on the auditor's report.

RECAP: The student to note that written representations do not form sufficient appropriate audit evidence on their own. Therefore, when the auditor receives such representations, he should:

- Seek collaborative audit evidence from sources inside or outside the entity
- Evaluate whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations
- Consider whether the individuals making the representations can be expected to be well-informed on the particular matters.

4.0 Conclusion

To be able to draw valid conclusions and issue appropriate report, the auditor needs to obtain sufficient appropriate evidence. Some of such evidence may be provided by experts or even the internal audit function of the client company. In addition the auditor also seeks evidence in respect of accounting estimates and related party relationships and transactions, all of which constitute high audit risk areas for the auditor. Before concluding his report the auditor requires management to give written representations regarding the preparation and presentation of the financial statements, information provided to the auditor and management responsibilities including other representations required by specific ISAs.

5.0 Summary

In this unit, we have examined the nature, relevance and quality of audit evidence as a basis for auditor's opinion on a set of financial statements. In addition, the unit discussed the requirements of ISAs 620, 610, 540 and 550 audit risk areas that require sufficient appropriate evidence.

6.0 Tutor-marked Assignment

An expert or specialist is a firm or person that possesses special skills in a profession other than accountancy or auditing.

Required

1a. Identify five areas in which evidence from experts may be required and justify the need to consult an expert in each area. (10 marks)

b. Explain **five** factors to be considered before placing reliance on the report of an expert. (3 marks)

c. What options are available to an auditor if the work of an expert does not provide sufficient appropriate audit evidence or is inconsistent with other audit evidence? (2 marks)

(Total: 15 marks)
(ICAN adapted)

2**.** You are theaudit manager reviewing the completed audit file of Okenwa Oil Co.

a). There have been no events subsequent to the period end requiring adjustments in the financial statements.

b). The company has revalued two properties in the year. The directors believe that the property market is going to boom next year, so have decided to revalue the other two properties then.

c). The directors confirm that the company owns 75% of the newly formed company, Suboil Co., at the year end.

d). The directors confirmed that the 500 barrels of oil in Ikere Warehouse belong to Floxy Oil Co.

Required

Comment on whether you would expect to see these matters referred to in the letter of representation. (ACCA adapted)

3. The auditor has a responsibility to design audit procedures to obtain sufficient and appropriate evidence.

Required:

a. State and explain **five**procedures for obtaining evidence**.**
b. For each procedure, describe an example relevant to the audit of purchases and other expenses. (ACCA)

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST
2. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International
3. International Standards on Auditing 500, 540, 550, 580, 610, 620 and IAS 24.

UNIT 12: EVALUATION AND REVIEWS

Content

1.0 Introduction

After all tests (compliance and substantive), the auditor reviews and evaluates the evidence he has gathered in order to satisfy himself that they can support conclusions reached. In this unit, we will deal with the broader review of other information and events the auditor undertakes before the reports are written.

2.0 Objectives

By the end of this unit, you should be able to:

- Demonstrate your understanding of the requirements of ISA 450 *Evaluation of misstatements.*
- Discuss the auditor's roles with respect to events after the reporting period (subsequent events)
- Explain the auditor's responsibility for opening balances
- Explain the going concern concept and discuss the indicators of going concern problem

Explain the auditor's procedures when there are uncertainties regarding going concern of the client's entity.

3.0 Main Content

3.1 Evaluation of misstatements (ISA 450)

The auditor needs to report whether the financial statements he has audited were materially misstated or not. To reach that conclusion, he will need to make an overall evaluation of the level of errors he has found in the financial statements and compare that with the materiality thresholds that were set at the planning stage.

According to ISA 450, the auditor should evaluate the effect of identified misstatements on the audit, and any uncorrected misstatements on the financial statements. A misstatement could be in relation to the amount, classification, presentation or disclosure of an item.

ISA 450 requires the auditor to carry out the following procedures:

i. Accumulate all misstatements found during the audit, unless they are clearly trivial.
ii. If the total of misstatements identified during the audit approach (or could approach) materiality, decide if the overall audit strategy and audit plan need to be revised.
iii. Communicate all misstatements found during the audit to an appropriate level of management and request that the misstatements be corrected.
iv. If management refuse to correct the misstatements obtain the reasons for this and take those reasons into account when evaluating whether the financial statements as a whole are free from material misstatement.
v. Prior to evaluating the effect of uncorrected misstatements reassess materiality in line with the requirements of ISA 320.
vi. Decide whether uncorrected misstatements are material, individually, or in aggregate.Consider the size, nature and impact/circumstances of the misstatements and the effect of any uncorrected misstatements from prior periods.
vii. Communicate to those charged with governance the effect that uncorrected misstatements may have on the audit report.
viii. Request a written representation from management as to whether they believe the effect of uncorrected misstatements are immaterial, individually, or in total.
ix. Documentthe amount below which misstatements would be regarded as trivial; all misstatements accumulated during the audit and whether they have been corrected and his conclusion as to whether uncorrected misstatements are material, individually, or in total.

3.2 ISA 510: Initial audit engagements – opening balances

Errors in opening balances affect the figures for the current financial period because figures for current year transactions are built into the opening balances. The auditor therefore needs to be sure that the opening balances are correct.

There are two dimensions to auditor's responsibilities in relation to opening balances. These are
a. where the financial statements for the prior period were not audited; and
b. where the financial statements for the prior period were audited by the predecessor auditor.
In each of the above cases,the auditor's objectives are to obtain sufficient appropriate audit evidence about whether:

- the opening balances contain misstatements that materially affect the current period's financial statements, and
- appropriate accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

Required Audit Procedures

i. Read the most recent financial statements and audit report, if any, for information relevant to opening balances.
ii. Check that the prior period's closing balances have been correctly brought forward.
iii. Check that opening balances reflect appropriate accounting policies.
iv. Perform one or more of the following procedures:
    - Where the prior period financial statements were audited, review the predecessor auditor's working papers to obtain evidence concerning opening balances.
    - Consider whether audit procedures carried out in the current period provide evidence on some of the opening balances, e.g. cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
    - Carry out a review of the audit report on the financial statements for the previous period to obtain evidence concerning opening balances.
v. If evidence is found that opening balances contain material misstatements affecting the current period's financial statements, assess the effect, and communicate this to those charged with governance.
vi. Check that the accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

3.3 ISA 710: Comparative information

CAMA, Cap C20, LFN 2004 requires that financial statements present comparative figures for previous year. The auditor therefore, tries to ensure that comparative figures have been correctly reported as required by the applicable financial reporting framework, and appropriately classified.

Required Audit procedures

The auditor should evaluate whether:

i. the comparative information agrees with the previous period, or, where appropriate has been restated; and
ii. accounting policies have been consistently applied in the two periods, or, if there have been changes in accounting policies, whether those changes have been properly dealt with.

He should also obtain written representations which cover all periods referred to in his opinion.

3.4 Subsequent events (IAS 10 and ISA 560)

Material events that occur after the reporting period but before the audit reports are authorized for issue should be considered when preparing the financial statements for the current year as they may affect the fair presentation/true and fair view of the financial statements.

IAS 10

IAS 10 defines events after the reporting period as 'those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorised for issue.'

These events may be:

i. *Adjusting events*: These are events that provide evidence of conditions that already existed at the end of the reporting period.
ii. *Non-adjusting events*: These are events that have occurred due to conditions arising after the reporting period.

Accounting for adjusting events after the reporting period

IAS 10 states that 'an entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.'

The following are examples of adjusting events per IAS 10:

a. The settlement after the reporting period of a court case, confirming that the entity had a present obligation as at the end of the reporting period as a consequence of the case.
b. The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period.
c. The discovery of fraud or errors showing that the financial statements are incorrect

Disclosures for non-adjusting events after the reporting period

A non-adjusting event relates to conditions that did not exist at the end of the reporting period. The financial statements must not be adjusted/updated to include the effects of the event.

For material non-adjusting events, IAS 10 requires disclosure of the nature of the event, and an estimate of its financial effect, or a statement that such an estimate cannot be made. This information should be disclosed in a note to the financial statements.

Examples of non-adjusting events include:

i. A fall in value of an asset after the reporting period,e.g. a large fall in the market value of some investments owned by the entity.
ii. The acquisition or disposal of a major subsidiary.
iii. The formal announcement of a plan to discontinue a major operation.
iv. Announcing or commencing the implementation of a major restructuring.
v. The destruction of a major plant by a fire after the reporting period.

The role of the auditor: ISA 560 *Subsequent events*

In evaluating and reviewing subsequent events, the objectives of the auditor, are to obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements, and to respond appropriately to facts that became known to him after the date of the audit report that, had they been known to him at that date, may have caused him to amend his report.

There are two key dates after the reporting period: the date of the audit report and the date that the financial statements are issued. Before the issue of the audit report, the auditor *actively looks for* significant subsequent events. Thereafter and up to the date of issuing the financial statements, he only considers the impact of significant subsequent events that come to his attention.

Audit work to check compliance with IAS 10

To check compliance with IAS 10, the auditor evaluates and reviews events:

a. from the end of the reporting period to the date of the audit report
b. from the date of audit report to the date that the financial statements are issued; and
c. after the financial statements have been issued.

a. **Events occurring after the reporting period and up to the date of the audit report** Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements have been identified, and are suitably reported in the financial statements.

Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. He should:

- obtain an understanding of management's procedures for identifying subsequent events
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity's latest subsequent financial statements
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not yet available
- obtain written representations in respect of subsequent events.

b. **Events from the date of audit report to the date that the financial statements are issued**

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for events of which he becomes aware, up to the time that the financial statements are issued. He is not required, during this period, to actively look for subsequent events.

If the auditor becomes aware of a fact that, had it been known to him at the date of the report, may have caused him to amend his report then he must:

a. discuss the matter with management,
b. determine whether the financial statements need amending, and
c. inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to carry out the necessary audit procedures on the amendment(s), and extend his review of subsequent events up to the date of the new audit report.

If management fails to amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor should modify his opinion as appropriate if the audit report has not yet been provided to the entity. But if the audit report has been provided to the entity, the auditor should instruct management not to issue the financial statements before the necessary amendments have been made. Where management goes ahead to issue the financial statements, he should take appropriate action to prevent reliance on the audit report, after taking legal advice.

c. **Events after the financial statements have been issued.**

If an auditor becomes aware of a fact that, had it been known to him at the date of his audit report, may have caused him to amend his report then he should:

i. discuss the matter with management
ii. determine how the financial statements need amending, and
iii. inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment

- extend his review of subsequent events up to the date of the new audit report
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- issue a new audit report, containing an emphasis of matter paragraph or other matter paragraph. This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

3.5 Going Concern (ISA 570)

The going concern assumption means that the income statement/statement of comprehensive income and statement of financial position are prepared on the assumption that the entity will continue in operational existence for the foreseeable future. If the entity is not a going concern, there will be significant implications for the financial statements. For example, all assets and liabilities become 'current' and all assets must be carried in the statement of financial position at their exit or net realisable value, and there may be additional liabilities..

Going concern: duties of the directors

In preparing the financial statements, the directors must satisfy themselves (in accordance with IAS 1) that the going concern basis is appropriate. It is therefore the responsibility of management to make the going concern assessment.

Going concern: duties of the auditor (ISA 570)

According to ISA 570, the audit objectives with regard to going concern are to:

i. obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements.
ii. conclude whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern, and
iii. determine the implications for the audit report.

Where management has not performed going concern assessment, the auditor per ISA 570, must perform risk assessment procedures to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Factors that raise questions about the going concern assumption

The auditor should remain alert throughout the audit process for factors or events that may indicate that the going concern status could be doubtful. Examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption include:

Financial conditions/indicators

i. Net liability or net current liability position.
ii. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
iii. Indications of withdrawal of financial support by creditors.
iv. Negative operating cash flows indicated by historical or prospective financial statements.
v. Adverse key financial ratios.
vi. Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
vii. Arrears or discontinuance of dividends.
viii. Inability to pay creditors on due dates.
ix. Inability to comply with the terms of loan agreements.
x. Change from credit to cash-on-delivery transactions with suppliers.
xi. Inability to obtain financing for essential new product development or other essential investments.

Operating conditions/indicators

i. Management intentions to liquidate the entity or to cease operations.
ii. Loss of key management without replacement.
iii. Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
iv. Labour difficulties (e.g. riot, strike or conflict).
v. Shortages of important supplies.
vi. Emergence of a highly successful competitor.

Other conditions/indicators

i. Non-compliance with capital or other statutory requirements.
ii. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
iii. Changes in law or regulation or government policy expected to adversely affect the entity.
iv. Uninsured or underinsured catastrophes when they occur.

The significance of such conditions can be mitigated by other factors. For example, the loss of a key supplier may be mitigated by the availability of a suitable alternative source of supply. The *size* of an entity and its '*reserves base*' also plays a role on its ability to withstand adverse conditions.

Going concern assumption: audit procedures

Where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern the auditor must obtain sufficient appropriate evidence to determine whether or not a material going concern uncertainty exists through performing additional audit procedures. These procedures shall include:

i. Discuss with management to confirm the reasons why they consider the going concern assumption to be valid and their future plans for the business
ii. Obtain a cash flow forecast and assess the appropriateness of the assumptions used. If there is a forecast of a cash shortage, the auditor should discuss with management their plans for obtaining the additional financing that will be required.
iii. Review the sales order book. If this indicates a decline in sales orders, the issue should be discussed with management.
iv. Review ageing receivables and assess the average collection period (ACP). A lengthening of the ACP may have adverse implications for operational cash flow.
v. Consider whether planned capital expenditure by the entity may be insufficient to support the business as a going concern in the future.
vi. If a key senior employee has left the business entity in the recent past, the possible implications (for example, the possibility of losing key customers with the loss of the key employee) should be discussed.
vii. Enquiring of the entity's legal counsel regarding litigation and claims. Assess the implications for cash flow and the continuity of the entity.
viii. Obtain written confirmation from bankers and other loan creditors (in appropriate cases) that expected continuing financial support will remain available.
ix. Obtain a letter of representation from management confirming their opinion that the entity is a going concern.

Note: Where there is a disagreement between management and the auditor concerning the going concern status of the entity the auditor should consider the implications on the report to members of the company (he may consider making a qualified audit report).

4.0 Conclusion

Before issue the independent auditor's report, the auditor undertakes a review of events and transactions that may have impact on the validity of his conclusions and the resultant report he issues. These transactions and events include opening balances, comparative figures, events (adjusting and non-adjusting) after the reporting period as well as the going concern assumption.

5.0 Summary

This unit dealt with the evaluation of misstatements in accordance with ISA 450, the effect of opening balances on current period figures, comparative figures, subsequent events, going concern assumption and the auditor's duties in respect of these matters.

6.0 Tutor-marked assignment

1. With reference to ISA 560, explain the auditor's responsibility in respect of events after the reporting period.

2.(a) Define 'going concern'.

(b) Explain the director's responsibilities and the auditor's responsibilities regarding financial statements prepared on the going concern principle.

(c) Describe **five**auditprocedures an auditor should perform in assessing whether or not an entity is a going concern.

3(a) Explain the term 'misstatement' and describe the auditor's responsibility in relation to misstatements.

(b). Describe the auditor's procedures when evaluating the effect of misstatements on financial statements and the auditor's report.

7.0 References/further reading

1. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International
2. International Standards on Auditing 450, 510, 560, 710 and IAS 10.

UNIT 13: REPORTING I (ISA 700 *revised*)

THE INDEPENDENT AUDITORS' REPORT

Content

1.0 Introduction.

In this unit, we shall examine part 1 of the reporting requirements of the independent auditor, the auditor's report to members of the company, based on the revised ISA 700. We shall also examine the modification of the auditor's report in line with ISAs 705 and 706.

2.0 Objectives

By the end of this unit, you should be able to:

- Understand the requirements of ISA 700 on forming an opinion on a set of financial statements.
- Discuss the elements of the independent auditor's report per ISA 700 (*revised*)
- Explain the matters to be specifically stated in the auditor's report in line with schedule 6, CAMA, Cap C20 LFN 2004.
- With reference to ISA 701, explain the term 'key audit matters' and the implication of their inclusion in the Independent auditor's report.

3.0 Main Content

3.1 The Independent Auditor's Report

The independent auditor’s report is the end product of every audit. Usually the auditor issues two reports namely:

A. Report to members of the company as required by ss. 359 & 360 of Companies and Allied Matters Act CAP C20 LFN 2004 and ISA 700/NSA 28 – *The Independent Auditor’s Report on a complete set of General purpose Financial Statements*; and

B. Report to those charged with Governance (ISA 260/NSA 7), communicating some important audit matters that came to attention during the course of the audit, including deficiencies in internal control per ISA 265.

The revised ISA 700 is designed to reduce the communication gap between the auditor and users of the auditor’s report/services. The format of the report given herein is line with the requirements of ISA 700 (revised) with an effective date of December 15, 2016.

3.1.1.The Independent Auditor’s Report to Members of the Company

By the s. 359(1) of CAMA, the independent “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 laid before the company in a general meeting during the auditors’ tenure of office.” The Act requires that the auditor states in the report whether in his opinion, the accounts:

- Show a true and fair view
- Comply with the requirements of relevant sections of the Act.

ISA 700 equally states that “the Auditor’s report should contain a clear expression of the auditor’s opinion on the financial statements.” Thus after gathering all necessary audit evidence and reviewing all after Balance sheet events, the auditor expresses on the financial statements he has reviewed.

3.1.2. Forming an Opinion on a set of financial statement

ISA 700 requires that the auditor should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements.

When forming an opinion on a set of financial statements, an auditor evaluates, based on evidence obtained, whether:

a. The financial statements taken as a whole are free from material misstatements, that is, whether sufficient appropriate evidence has been obtained to reduce to an acceptably low level, the risks of material misstatements as well as evaluating the effects of uncorrected misstatements identified.
b. The financial statements have been prepared and presented in accordance with the specific requirements of applicable legislation for particular classes of transactions, account balances and disclosures; and

c. After any adjustments made by management as a result of the audit process, the financial statements have been fairly presented and are consistent with the auditor's understanding of the entity and its environment.

The above evaluation includes considering whether, in the context of the applicable reporting framework:

(a). the financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

3.1.3 The Basis and Elements of Auditor's Report (Effective from December 15, 2016)

Companies and Allied Matters Act CAP C20 LFN 2004, gives the legal requirements as to content of the auditor's report but not the format. But ISA 700 provides details of the basis and elements/format of the auditor's report for audits conducted in accordance with International standards on Auditing.

Elements/ Format of an Auditor's Report

1. Title

This should clearly indicate that it is an independent auditor's report – 'Independent Auditor's Report.'

2. Addressee

The enabling law, regulation and circumstances of the engagement determine the addressee and specify this. In Nigeria, the independent auditor's report for audit of companies is addressed to members of the companies.

3. Auditor's Opinion

This shall have the heading "Opinion."

The Opinion section of the auditor's report shall:
(a) Identify the entity whose financial statements have been audited;
(b) State that the financial statements have been audited;
(c) Identify the title of each statement comprising the financial statements;
(d) Refer to the summary of significant accounting policies and other explanatory notes and
(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.
An unmodified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly in all material respects, in accordance with the applicable framework.

4. Basis for Opinion

This section:

(a) States that the audit was conducted in accordance with International Standards on Auditing;
(b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;

(c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code); and

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. Going Concern

Where applicable, the auditor shall report in accordance with ISA 570 (Revised): Where the auditor agrees with management's use of going concern basis, and there is a material uncertainty which may cast a significant doubt on the going concern of the entity, and which has been adequately disclosed, the auditor should issue an unmodified report. He should however, add a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial statements that discloses the matters concerning the material uncertainty.

6. Key Audit Matters

The auditor is required to communicate key audit matters in the auditor's report in accordance with ISA 701. Communicating key audit matters (KAM) enhances the communicative value of the auditor's report by providing greater transparency about the audit that was performed. KAM assists users understand those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period e.g. areas of higher assessed risk of material misstatement, or significant risks; significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty, as well as effect on the audit of significant events or transactions that occurred during the period.

However, where an auditor disclaims an opinion on a set of financial statements, KAM shall not be communicated.

11 Management's Responsibilities for the financial Statements

The report should state that the management is responsible for the preparation and fair presentation of the financial statements in accordance with the provisions of CAMA. Management's responsibility includes –

- Designing, implementing and maintaining the internal control system relevant to the preparation and fair presentation of financial statements that are free from material misstatements whether due to error or fraud.
- Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

***8. Auditor's Responsibility for the Audit of the Financial Statements**

The auditor's report shall:

(a) State that the objectives of the auditor are to:

(i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

(ii) Issue an auditor's report that includes the auditor's opinion.

(b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and

(c) State that misstatements can arise from fraud or error, and either:

(i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or

(ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

(d) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

(e) Describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion.

(ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

Note: In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Note: If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(f) When ISA 600(Group audit) applies, further describe the auditor's responsibilities in a group audit engagement by stating that:

(i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;

(ii) The auditor is responsible for the direction, supervision and performance of the group audit; and

(iii) The auditor remains solely responsible for the auditor's opinion**.**

(g) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

(h) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

(i) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with ISA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

Note: The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

9. Other Reporting responsibilities

Laws, standards or generally accepted practice may require or permit an auditor to report on other matters that provide further explanation of the auditor's responsibility. Such matters may be addressed in a separate paragraph following the auditor's opinion e.g. compliance with CBN regulations or the requirements of the Insurance Act or even the legal requirements on content of auditor's report as stipulated by schedule 6, CAMA, Cap C20, LFN 2004.

This section shall be titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section.

10. Name of the Engagement Partner

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat, the severity of which has to be discussed and agreed with those charged with governance.

11. Auditor's signature

The report is signed by the engagement partner or in both the name of the audit firm, and the engagement partner. The Auditor also declares his professional accountancy designation and membership number as well as his FRC number.

12. Date of the Report

The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

(a) All the statements that comprise the financial statements, including the related notes, have been prepared; and

(b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

13. Auditor's Address

The report should name the location in the country where the auditor practices**.**

*** Note:** The description of the auditor's responsibilities for the audit of the financial shall be included either:
(a) Within the body of the auditor's report; or
(b) Within an appendix to the auditor's report (the report shall include a reference to the location of the appendix); or
(c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

3.1.4 Content of Auditor's Report (Summary of matters to be expressly stated in the auditor's report): Schedule 6, CAMA, Cap C20, LFN 2004

Schedule 6, CAMA, Cap C20, LFN 2004 stipulates that the auditors' report shall include specific statements to the effect that:

a. They have obtained all information and explanations which to the best of their knowledge and belief were necessary for the purpose their audit.
b. In their opinion proper books of account have been kept by the company, so far as appears from their examination of those books and proper returns adequate for the purpose of their audit have been received from branches not visited by them.

c. In their opinion the Balance Sheet (Statement of financial position) and the Profit and loss account (Statement of Comprehensive Income) dealt with by the report are in agreement with the books of account and returns.
d. In their opinion, and to the best of their information and according to the explanations given them, the financial statements give a true and fair view and
e. In the case of a holding company, in their opinion, the group financial statements have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries and associates.

Samples of an Unmodified Independent Auditor's Report

Sample 1

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company Plc

Report on the Audit of the Financial Statements

1 **Opinion**

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Nigeria and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with ISA 701*.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

*As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control

Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

****Report on Other Legal and Regulatory Requirements**

The Companies and Allied Matters Act, CAP C20 LFN, 2004 requires that in carrying out our audit we consider and report to you on the following matters. We confirm that:

i. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.
ii. In our opinion, proper books of account have been kept by the Company; and
iii. The Company's Statement of Financial Position and the Statement of Profit or loss account and other Comprehensive Income are in agreement with the books of account.

The engagement partner on the audit resulting in this independent auditor's report is **…………….**

[Signature in the name of the audit firm, the personal name of the engagement partner, or both, as appropriate, including membership status and number and FRC number.]

Chartered Accountants
Aba, Nigeria
Date……………………………….

*****_This section of the report can be attached as an appendix to the report_

***Depending on the nature of the entity, other industry-specific requirements will be accommodated in this section.*

Sample 2

Independent AUDITOR'S REPORT (up to December 14, 2016)

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF ……………………………..

We have audited the accompanying financial statements of …………………. for the year ended 31 December 20..set out on pages -- to -- which have been prepared on the basis of the significant accounting policies on pages -- and -- other explanatory notes on pages -- to --.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with Nigerian statements of Accounting Standards and with the requirements of the Companies and Allied Matters Act, CAP C20, LFN 2004. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an independent opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the company's financial position as at 31 December 20..and of its financial performance and cash flows for the year then ended in accordance with the Companies and Allied Matters Act, CAP C20, LFN 2004, and with the Nigerian Statements of Accounting Standards.

Report on other legal requirements

The Companies and Allied Matters Act, CAP C20 LFN, 2004 requires that in carrying out our audit we consider and report to you on the following matters. We confirm that:

i. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

ii. In our opinion, proper books of account have been kept by the Company; and

iii. The Company's Statement of Financial Position and the Statement of Profit or loss account and other Comprehensive Income are in agreement with the books of account.

Chartered Accountants
Aba, Nigeria
Date……………………………….

3.1.5 When an Unqualified Opinion is appropriate

The auditor may issue a standard unqualified report as above or in appropriate circumstances, may modify the wordings of his report. Whenever the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework, he issues an unqualified report.

Implications of an unqualified report: In an auditor's report on financial statements an unqualified opinion is issued when the auditor is satisfied in all material respects that:

1. proper accounting records have been kept and proper returns obtained from branches not visited by the auditor and the financial information has been prepared using acceptable accounting policies which have been consistently applied;

2. the financial statements agree with the underlying records and returns and comply with relevant regulations and statutory requirements;

3. all information and explanations needed have been received from directors, management and staff;

4. the auditor had unrestricted access to all records and books;

5. there are no material errors or misstatements in the financial statements;

6. the view presented by the financial statements as a whole is consistent with the auditor's knowledge of the business of the entity; and

7. there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, including disclosure requirements of sect. 360(4) of CAMA (that is, disclosure of all transactions involving the directors and all matters relating to employees remunerated at higher rates).

Self-assessment question

Briefly describe the elements of the independent auditor's report (clean report).

3.2 Modified Audit Report (ISAs 705/706)

An auditor modifies the wordings of his report in the following situations:

i. Matters that do not affect the Auditor's opinion

- Emphasis of matter paragraphs and other matter paragraphs (ISA 706).

ii. Matters that do affect the Auditor's opinion (ISA 705)

a) Qualified opinion
b) Disclaimer of opinion
c) Adverse opinion.

Matters that do not affect the auditor's opinion.

Emphasis of matter (EOM): In certain circumstances, the auditor's report may be modified by adding an emphasis of matter paragraph to highlight and draw users' attention to a matter presented or disclosed in the financial statements which is fundamental to an understanding of the financial statements. Such a matter usually is extensively discussed in a note to the financial statements.

ISA 706 states that the paragraph must only be used when the auditor has sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. EOM does not relate to a disagreement or a limitation in scope, and therefore is not in any way a qualification of the audit opinion. It is not a substitute for:

- Reporting in accordance with ISA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;
- A modified opinion when required by the circumstances of a specific audit engagement; or
- Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation

Depending on the nature of information to be communicated, the paragraph may be placed after the basis of opinion to provide appropriate context to the auditor's opinion or either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

Emphasis of matter paragraph may be added under the following circumstances:

- ❖ To highlight an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- ❖ To highlight a significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- ❖ Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- ❖ A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Other Matter (OM) Paragraph

An Other Matter (OM) paragraph, like the EOM does not modify the auditor's opinion. However, it refers to information that is rightly not present in the financial statements, but which is so important for user's understanding of them that it needs to be highlighted in the auditor's report. It highlights matters relevant to other reporting responsibilities of the auditor. The OM is thus a means for the auditor to communicate with users, and should state explicitly that the matter referred to is not required to be included in the financial statements.

Examples of such situations include:

- Where local law, regulation or generally accepted practice requires or permits the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon e.g the planning and scoping of the audit.

- Where the auditor is not able to withdraw from an engagement even when a limitation on the scope of the audit imposed by management is pervasive (OM used to explain why).
- Where the auditor may be reporting on more than one set of financial statements (e.g. a set of statements prepared under national GAAP, and a set prepared under IFRS).
- Any restrictions on the distribution of the auditors' report: If the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.
- If revision of 'other information' issued with audited financial statements (e.g. information in the director's report inconsistent with figures in financial statement) is considered necessary by the auditor but management refuses to make the revision.

Placement of OM paragraph

i. When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.
ii. When an Other Matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
iii. When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the the Report on Other Legal and Regulatory Requirements.

3.2.2 Matters that do affect the auditor's opinion

An auditor may not be able to express an unqualified opinion when the under-listed circumstances exist and in the auditor's judgment, their effect may be material to the financial statements:

a. there is limitation on the scope of the auditor's work or

b. there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial disclosures.

The circumstances in (a) could lead to a qualified opinion or a disclaimer of opinion while the circumstances in (b) could lead to a qualified opinion or an adverse opinion.

Qualified/'Except for' Opinion is expressed when an auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management or limitation of scope is not so material and pervasive as to require an adverse opinion or disclaimer of opinion e.g stock figures not agreed between auditor and directors, inadequate provisions for bad debts are made etc.

A 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 evidence and is unable to express an opinion on the financial statements e.g. access is denied to vital information such as significant claims or litigation against the company.
The auditor shall also disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

An 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. That is, an adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
Examples of circumstances include:

- Failure to comply with the Act or the accounting standards without an acceptable reason
- Significant uncertainties regarding the existence, ownership and valuation of assets and liabilities
- There exist threats to the company's going concern status and the financial statements have been prepared on going concern basis etc.

Basis for Opinion
When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by ISA 700 (Revised):
(a) Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
(b) Within this section, include a description of the matter giving rise to the modification.

Note: Whatever is the basis of the qualification/modification, the auditor needs to:

a) Include in the report, a clear description of the substantive reasons
b) Detail the implications to the financial statements
c) Where possible, quantify the financial effect.

SUMMARY OF EACH TYPE OF MODIFIED OPINION AS REQUIRED (PER ISA 705)

Nature of Matter Giving Rise to the Modification	**Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements**	
	Material but Not Pervasive	*Material and Pervasive*
Financial statements are	Qualified Opinion	Adverse Opinion

materially misstated		
Inability to obtain sufficient appropriate audit evidence	Qualified Opinion	Disclaimer of Opinion

The concept 'Pervasive'

Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Limitation on Scope (inability to obtain sufficient appropriate evidence)

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(a) Circumstances beyond the control of the entity, for example, destruction of an entity's accounting records or indefinite seizure of the accounting records of a significant component by governmental authorities.

(b) Circumstances relating to the nature or timing of the auditor's work, e.g. the timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.

(c) Limitations imposed by management, for example, Management prevents the auditor from observing the counting of the physical inventory or Management prevents the auditor from requesting external confirmation of specific account balances such as bank balances, Accounts receivables etc.

Possible implications/consequences of a qualified Report

1) Shareholders' confidence in the company and its management may be affected.
2) Potential investors may be discouraged.
3) Fund providers/lenders may be unwilling to continue to extend facilities
4) Company's credit worthiness with suppliers may be affected.

Self-assessment question

Explain the term 'emphasis of matter paragraph' and describe the circumstances when an emphasis of matter paragraph may be used.

4.0 Conclusion

The auditor issues a report to shareholders and also a report to those charged with governance. His report to members of the company may be a clean report or a modified report. The report may be modified by the inclusion of an emphasis of matter paragraph or other matter paragraph which do not affect the auditor's opinion. Modifications that affect the auditor's opinion include disclaimer, adverse opinion and 'except for' qualified opinion. These latter forms of modification are caused either by disagreement on matters affecting the financial statement or limitation on the scope of the auditor's work.

5.0 Summary

This unit dealt with the independent auditor's report based on the revised ISA 700. Requirements of ISA 705 *Modification of the independent auditor's report* were also examined. The unit also looked at circumstances when it may be necessary to include an emphasis of matter paragraph and other matters paragraph in the auditor's report.

6.0 Tutor-marked Assessment

1.You are the audit manager in charge of the audit of Okoroji Co. Ltd, a client of Innocent Anyahuru & Co, a firm of Chartered Accountants. The financial year end for this client is 31 December 2014.

You are reviewing the audit senior's proposed audit report for Okoroji Co. Ltd.

In October 2014 a legal claim was filed against Okoroji Co. Ltd, a retailer of toys. The claim is from a customer who slipped on a greasy step outside one of the retail outlets. The matter has been fully disclosed as a material contingent liability in the notes to the financial statements, and audit working papers provide sufficient evidence that no provision is necessary as Okoroji Co. Ltd's lawyers have stated in writing that the likelihood of the claim succeeding is only possible.

The amount of the claim is fixed and is adequately covered by cash resources.

The audit senior proposes that the audit opinion for Okoroji Co. Ltd should not be qualified, but that an emphasis of matter paragraph should be included after the audit opinion to highlight the situation.

Required:
Evaluate whether the audit senior's proposed audit report is appropriate, and where you disagree with the proposed report, recommend the amendment necessary to the audit report.

2. You are an audit manager in Banjoko & Co, a firm of Chartered Accountants, responsible for the audit of Marigold Co, with a year ended 28 February 2015. The draft financial statements recognized profit for the year of ₦11 million. The audit for the year end is nearing completion, and several matters have been highlighted for your attention by the audit senior, Promise Nwagbara. The matters have been discussed with management and will not be adjusted in the financial statements:

i. In January 2015 a major customer went into administration. There was a balance of ₦2·5 million owing to Marigold Co from this customer at 28 February 2015, which is still included in trade receivables.

ii. A court case began in December 2014 involving an ex-employee who is suing Marigold Co for unfair dismissal. Lawyers estimate that damages of ₦50,000 are probable to be paid. The financial statements include a note describing the court case and quantifying the potential damages but no adjustment has been made to include it in the statement of financial position or the statement of profit or loss.

Promise Nwagbara has produced a draft audit report for your review, an extract of which is shown below:

Basis for opinion and disclaimer of opinion
We have performed our audit based on a materiality level of ₦1·5 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Marigold Co, Rita Akerele, has refused to make an adjustment to write off a significant trade receivables balance. Therefore in our opinion the financial statements of Marigold Co are materially misstated and we therefore express a disclaimer of opinion because we do not think they are fairly presented.

Emphasis of Matter paragraph:

Marigold Co is facing a legal claim for an amount of ₦50,000 from an ex-employee. In our opinion this amount should be recognised as a provision but it is not included in the statement of financial position. We draw your attention to this breach of the relevant IFRS.

Required:
Critically appraise the proposed auditor's report of Marigold Co for the year ended 28 February 2015.

*Note: You are **NOT** required to re-draft the extracts from the auditor's report.*

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011)**.** Auditing, 11th Edition, London: BookPower/ELST
2. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International
3. International Standards on Auditing 700, 701, 705 and 706.

UNIT 14: REPORTING II

Content

1.0 Introduction

As mentioned in unit 13, the auditor writes two reports namely, report to members of the company and report to those charged with governance. In this unit we shall discuss the report to those charged with governance as required by ISAs 260 and 265.

2.0 Objectives

By the end of this unit, you should be able to:

- Discuss matters of governance interest to be communicated to those charged with governance per ISA 260
- Describe the purposes/advantages of a management letter
- Explain the form and content of a management letter.

3.0 Main Content

3.1 Auditor's Report to Those Charged with Governance (ISA 260/265)

ISA 260/NSA 7 "Communication of Audit Matters with Those Charged with Governance" requires that the auditor communicates audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. 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, and which in the opinion of the auditor are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process.

The auditor should determine relevant persons who are charged with governance for the purpose of communicating matters of audit interest.

3.2 Audit Matters of Governance Interest

Audit matters of governance interest ordinarily include

- Material weaknesses in internal control
- Non-compliance with laws and regulations
- Fraud involving management
- Questions regarding management integrity
- The general approach and overall scope of the audit
- The selection of, or changes in, significant accounting policies and practices that have a material effect on the financial statements
- The potential effect on the financial statements of any significant risk and exposures, such as pending litigation, that requires disclosure in the financial statements
- Significant audit adjustments that could materially affect the financial statements
- Material uncertainties relating to the entity's ability to continue as a going concern
- Disagreement with management about matters that could be significant to the entity's financial statements or the auditor's report
- Expected modifications to the auditor's report.
- Unadjusted/uncorrected misstatements aggregated by the auditor during the audit which management considers immaterial, both individually and in aggregate, to the financial statements taken as a whole.
- Any other matters agreed upon in the terms of the engagement.

The two formal means of communicating audit matters are:

- ❖ The letter of Engagement and
- ❖ The Management Letter, letter of weakness, internal control Memorandum or Constructive Service letter.

Matters relating to accounting system and the system of internal control such as any material weaknesses in accounting and internal control and the auditor's views on the company's accounting policies and financial reporting(commonly referred to as *reportable conditions*) are communicated through a *Management Letter*, the subject matter of ISA 265.

ISA 260 Communicating with those charged with governance

Auditor communicates with those charged with governance to provide useful feedback about the audit. Those charged with governance may be the Board of directors or the audit committee (a subcommittee of the board).

The objectives of the auditor in respect of ISA 260 are to:

(a) communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) obtain from those charged with governance information relevant to the audit;
(c) provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
(d) promote effective two-way communication between the auditor and those charged with governance.

Matters to be communicated

1. *The Auditor's Responsibilities in Relation to the Financial Statement Audit*: The auditor shall communicate with those charged with governance his responsibilities in relation to the financial statement audit, including that:

(a) He is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

2. *Planned Scope and Timing of the Audit*: The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

3. *Significant Findings from the Audit*: These are management letter points usually communicated along with deficiencies in internal control per ISA 265.

The auditor communicates

(a) His views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and

(ii) Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor's report, if any; and

(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

4. *Auditor Independence*: In the case of listed entities, the auditor shall communicate with those charged with governance (in writing),a statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and

(i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. For example, total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity; and

(ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Establishing the communication process

The communication with those charged with governance may be provided either in writing or orally. It could take place as a discussion between the auditor and an appropriate level of management e.g. the audit committee for a larger company.

Where oral communication would not be adequate, ISA 260 requires that communication is in writing, in the form of a letter or report. If communication is oral then the matters communicated, to whom and when must be documented.

Communication must be made on a timely basis. The appropriate timing will vary depending on the matter to be communicated. Communication in respect of planning matters will be likely to be made early in the engagement. Any significant difficulties encountered during the audit should be communicated as soon as practicable, especially if they are likely to lead to a modified opinion.

Actions when an audit report is to be modified

ISAs 705 and 706 require the auditor to communicate any planned modification to the auditor's report with those charged with governance. This is to ensure that those charged with governance understand that a modification is to be made and the reasons for it. Early communication also gives those charged with governance an opportunity to provide the auditor with further information and explanation prior to the issuance of the auditor's report.

ISA 265: Communicating deficiencies in internal control

A deficiency is defined by ISA 265 as wherea control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis, or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A significant deficiency is one which merits the attention of those charged with governance. ISA 265 requires the auditor to communicate significant deficiencies identified during the audit to those charged with governance in writing on a timely basis; and tocommunicate any other deficiencies to an appropriate level of management

The communication of significant deficiencies must be in writing and is required to cover:

- A description of the deficiencies and an explanation of their potential effects.
- Sufficient information to allow those charged with governance and management to understand the context of the communication, including an explanation that:
    a. the purpose of the audit was to express an opinion on the financial statements
    b. the audit did include consideration of internal controls in order to design appropriate audit procedures, and not for the purpose of expressing an opinion on the effectiveness of internal control, and
    c. the matters being reported are limited to those deficiencies identified during the audit and considered of sufficient importance to be reported.

The auditor will also usually state that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

3.3 The Management Letter

Main Object: To assist those charged with governance in improving the accounting system, the control environment and to highlight any matters that may be relevant to future audit.

Purposes/Advantages

1. To enable the auditor give his assessment of the accounting system, records and controls.
2. To enable the auditor bring to the attention of management areas of system weakness that may give room to material misstatements and errors.
3. To enable the directors and management to deal with and correct matters that could have led to the modification of the report to shareholders.
4. To enable the auditor point out to management areas where they could be more efficient and effective or where economies in the use of resources could result.
5. To enable the auditor communicate matters that may have an impact on future audits.
6. Serves as a good defence for the auditor, in case of litigation, that the weaknesses occasioning loss were brought to the attention of management.

Contents

The Management Letter usually includes the following maters–

i. The overall approach and scope of the audit, including limitations on the scope of the audit
ii. The accounting policies, and any changes to them, that could materially affect the financial statements
iii. Adjustments arising as a result of audit procedures which could materially impact the financial statements
iv. Material events or uncertainties which could jeopardise the going concern status and which require disclosure within the financial statements
v. Disagreements with management over accounting treatments or disclosures (including details of non-compliance with accounting standards or legislation)
vi. Any expected modifications of the audit report
vii. Material weaknesses discovered in the accounting and internal control systems.

Other relevant matters to be communicated may include:

- Details of any threats to independence and objectivity and of any safeguards adopted
- Explanations of the audit approach used, including materiality concept and its application to the audit process
- A summary of the business risks identified, including the auditor’s assessment of the likelihood of the risks materializing
- A review of the contents of the management’s representation letter

- Recommendations, where relevant, to help improve the entity's internal systems and controls.

Format

There is no set format but the report should highlight the following:

a) The weaknesses discovered
b) The implications for the company
c) The recommendations/corrective actions needed.

It is common to add a column for management's response after the 'implications'.

Note: Management's response to each of the issues raised is important. The response has to be discussed with them before finalization and submission of report

4.0 Conclusion

An important aspect of the audit is the communication of observed weakness/deficiencies and other matters of governance interest to those charged with governance for corrective action. This is done the management letter.

5.0 Summary

This unit surveyed the requirements of ISA 260 *Communicating with those charged with governance* and ISA 265 *Communicating deficiencies in internal control* and highlighted matters to be communicated to those charged with governance. It also described the form and content of a management letter and the benefits derivable therefrom.

6.0 Tutor-marked Assignment

1. Discuss **four** matters the auditor communicates to those charged with governance.

2. State the main object of a management letter and discuss **5** advantages of a management letter.

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST
2. ICAN(2014).Advanced Audit and Assurance Study text. UK: Emile Woolf International
3. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media

4. International Standards on Auditing 260 and 265.

UNIT 15: INVESTIGATIONS

Content

1.0 Introduction

This unit takes our study further to investigations. We mention different classes of investigation but treat in-depth the reporting accountant's investigation for the issue of a prospectus or statement in lieu.

2.0 Objectives

By the end of this unit, you should be able to:

- Distinguish between a conventional audit and an investigation
- Describe the legal requirements for the issue of a prospectus
- Define the term. 'reporting accountant' and discuss the role of a reporting accountant in the issue of a prospectus.
- Discuss the principal parties to the issue of a prospectus
- Discuss the reporting accountant's work programme for the review of financial forecasts.

Explain the matters the reporting accountant should clarify with his client before accepting an assignment and before commencement of his assignment as a reporting accountant.

3.0 Main Content

3.1 Investigation

3.1.1 Definition

Investigation is an inquiry commissioned by management for a specific purpose. "It is an act of examining, searching and inquiring into a matter with adequate care and accuracy, usually undertaken to obtain information of particular or special nature." – (Oremade, 1988).

An investigating accountant may or may not be the auditor of the entity but it should be noted that any accountant/auditor undertaking an investigation assignment is seen as an expert and he must therefore exercise great care and skill in working towards achieving the defined purpose/objectives laid down in the client's instructions.

The accountant should note that the matter under investigation may start as an internal matter that could eventually end up in court. Thus, great care and proper documentation is very important.

3.1.2 Investigation and Conventional Audit Compared.

S/NO.	POINT OF DIFFERENCE	AUDIT	INVESTIGATION
1.	OBJECTIVE	To report on the truth and fairness of the financial statements	Specified by client or arising from his specific needs.
2.	SCOPE	As laid down by statutes & GAAP and covers Entity's financial statements	As agreed with Client. May cover only specified areas of the fin. Statements.
3.	EXTENT OF REGULATION	Governed by the Companies' Act and Auditing standards/guidelines	Terms of reference agreed with Client governs the relationship or assignment.
4.	TIMING	Regular(usually annually)	Ad-hoc
5.	EXPECTED DEGREE OF CARE	Reasonable skill and care required and employed.	Much higher skill and care required and employed.
6.	DEPTH OF ENQUIRY	Reasonable enquiry as work covers every aspect of the fin. Statements.	More indepth enquiry. Work may be only on specific area(s) of Entity's affairs.
7.	QUALIFICATION	Statutes define and regulate qualification of an auditor.	Statutory qualification requirements not mandatory for an investigating Accountant unless specified by the requirements of a specific assignment e.g .a reporting Accountant must be a chartered Accountant in public practice.

3.1.3 Nature/Classes of Investigation

Investigations carried out by Accountants often fall into the following classes:

1. Investigations for investment purpose (including partnership participations) or purchase of a business.
2. Investigation for a lending banker (loan decisions).
3. Investigations under CAMA:
   - Under section 314 – Investigation into the affairs of a company on application by not less than 25% of members on the register of the company (for companies not having share capital) or not less than 25% of the class of shares issued.
   - Under section 315 – In response to sect. 314, CAC can appoint competent inspectors to investigate the affairs of a company and report on them, if the court orders so. Reasons for such investigation include, if there are circumstances suggesting that:

     i. the company's affairs are being or have been conducted with intent to defraud its creditors or the creditors of any other person or in a manner which is prejudicial to some part of its members; or

     ii. any actual or proposed act or omission of the company is or would be prejudicial or that the company was formed for any fraudulent or unlawful purpose; or

     iii. persons concerned with the company's formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards it or toward its members; or

     iv. the company's members have not been given all information with respect to its affairs which they might reasonably expect.
   - Under section 326 – investigation of the ownership of a company by CAC on the application of members as in sect. 314.
4. Investigation under Investment and Securities Act (ISA) 2007:
   - Under section 172 – investigation of a collective Investment scheme.
5. Investigation for financial crime, fraud, burglary or damage caused by fire.
6. Investigation preceding the issue of a Prospectus or statement in lieu of Prospectus
7. Investigation for business reorganizations and reconstructions or for mergers and acquisition schemes.
8. Tax investigations (Back duty).

3.1.4 Stages in carrying out an Investigation

1. Preparation

- Preliminary review- Background information about the client and the assignment, culminating in the acceptance of the client and assignment.
- Obtain written instructions from the client; agree on terms of reference.
- Planning.

2. Field Work

- Ascertaining the facts and obtaining information/evidence from relevant sources.
- Examination and verification of data/evidence obtained.

3. Reporting

- Analysis, interpretation and evaluation of evidence.
- Writing the report of the assignment

Note: Depending on the investigating accountant, the above stages may be modified, but in all cases, there must be detailed planning (giving the approach, time schedule etc), obtaining of sufficient evidence (including through the assistance of experts) and reporting.

3.1.5 Report Structure

1. Executive Summary

2. Detailed report:

i. Nature of the assignment
ii. Date commissioned (date client gave written instructions for the assignment)
iii. Scope of the assignment
iv. The approach adopted in carrying out the assignment
v. Findings and observations
vi. Conclusions and recommendations.

Note:

1. Tables, schedules, graphics and other visual aid, including memoranda of interviews add effect to the report.
2. The quality of the report is usually influenced by –
    - Independence of the investigator(s)
    - Integrity
    - Professionalism and sound judgment
    - Objectivity and fairness
    - Attention paid to details
    - Safety/quality of working papers.
3. The report must be
    - Accurate
    - Clear and unambiguous
    - Impartial and true
    - Timely
    - Relevant to the case.

Self- assessment question

1. Differentiate between a conventional audit and an investigation.

2. Describe the investigations that may be carried out under the Companies and Allied Matters Act 2004 and under the Investment and Securities Act 2007.

3.2 Reporting Accountant's Investigation on the issue of Prospectus or Statement in Lieu

3.2.1 Definitions

1. A reporting Accountant is a chartered Accountant in public practice who is reporting under the relevant provisions of CAMA and/or the listing requirements of the Nigeria Stock Exchange (NSE). He may or may not be the statutory auditor of the company on which he is reporting.

2. A prospectus means any prospectus, notice, circular, advertisement or other invitation, offering to the public for subscription or purchase, the shares or debentures of the company (see s.567 –CAMA).

An important content of any prospectus is the Accountant's report including the preceding 5 years financial summary and profit forecasts. The work of the accountant in this regard is challenging and demands caution, care and skill.

3.2.2 Issue of a Prospectus: Legal requirements.

The legal requirements relating to issue of prospectus as specified by Investment and Securities Act (ISA) 2007 are:

1. Sect.73 (1) – Every Prospectus issued by or on behalf of a company shall set out the reports specified in Part II of Sch.3 to the Act (i.e. the Auditor's/ Accountant's report).

Although the Act requires the report to be issued by the auditors of the company, sometimes an accountant is appointed to issue the report either as a sole Reporting Accountant or jointly with auditors.

2. By the provisions of s.77 (1), the report of the Reporting Accountant is not valid unless:

(a) he has given and has not, before delivery of a copy of the prospectus for registration withdrawn his written consent to the issue of it with the statement included in the form and context in which it is included and

(b) a statement that he has given and has not withdrawn his consent appears in the prospectus.

3. Sect.85 provides for civil liability for untrue statement (misstatement) in a prospectus. The persons liable include:

- Any director of the company at the time of the issue of the prospectus
- Any person who consented to be named and is named in the prospectus as a director
- Any employee of the company who participated in or facilitated the production of the prospectus
- The issuing house and its principal officers.

4. Sects. 86 & 87 Sect.85 provide for criminal liability for any director or officer who authorized the issue of a prospectus or Statement in lieu of prospectus containing an untrue statement (misstatement).

3.2.2a Principal Parties to an issue of a Prospectus/IPO

The principal Parties to an issue of Prospectus include:

1. **The Issuing House**
   - Acts as the financial adviser to the company as well as its agent.
   - assists in the selection of other professional advisers and co-ordinates their activities.
   - files registration application with SEC, prepares the prospectus and other offer documents for vetting and approval;
   - in appropriate circumstances, acts as the underwriter; and
   - joins the issuer in allotting shares and also filing returns on allotment with SEC.

2. **Broker(S) (The Marketing Agent) -**

   A stockbroker buys and sells securities on behalf of clients in return for a commission/fee called brokerage. The broker
   - Introduces the issue and the issuer to the market
   - Ensures that the listing requirements are known and complied with
   - Registers the issue with SEC
   - Joins in marketing the issue and ensuring its success.
   - Ensures that technical suspension is lifted at the appropriate time
3. **Registrar**
   - distributes offer documents which includes application forms, dockets etc to all receiving agents
   - receives returns from receiving agents for vetting and analysis.
   - prepares bases of allotment for consideration by issuer and the issuing house.
   - prepares and dispatches certificates to allottees.
   - dispatches returned monies to applicants in case of over subscription and brokerages to receiving agents.

4. **TRUSTEE**
    - Oversees the administration of the issue in order to ensure that the issuing company observes all the terms of the issue.

5. **Reporting Accountant**
    - Examines, reports and expresses opinion on the audited financial statements for relevant years; and
    - Examines and reports on the accounting policies, calculations and assumptions for the profit forecasts included in the Prospectus.

6. **The Auditor**
    - If not the Reporting accountant, liaises with the reporting Accountant and provides all financial information necessary for packaging the issue.
    - Also, undertakes financial projections.

7. **Receiving Banker**
    - Collects the proceeds of the issue
    - Returns excess money if over-subscribed.

8. **Solicitors to The Issue**:
    - Attends to and advises on all legal issues pertaining to the issue.
    - Works on the legal aspect of documentation
    - In the case of Debentures/bonds, he assists in drafting the Trust Deed.

3.2.3 Accountant's Report on Prospectus: Reporting Accountant's work Programme

The reporting Accountant's work programme should take care of the following matters:

1. Where the reporting accountant is different from the company's auditors, he should notify the auditors and solicit their full co-operation.
2. The reporting Accountant should read the following documents before start of work:
    i. Investment and Securities Act (ISA) 2007, noting particularly the following sections:
        a. Sect 73 – Contents of prospectus
        b. Sect 77 – Expert's statement in prospectus
        c. Sect 80 – Registration of prospectus
        d. Sect 90 – Application money for specified minimum subscription to be received before any allotment.
        e. Schedule 3 – mandatory contents of a prospectus
    ii. NSE listing requirements
    iii. Relevant sections of CAMA, including Sect 50 – Conversion and re-registration of private companies

3. Obtain the client's (or issuing House's) written instructions and ensure they include time table, scope of work and other special instructions on confidentiality.
4. From copies of the audited and management accounts, the reporting accountant should prepare summary of the Balance sheet and income statement for the immediately preceding 5 years. In doing this, he should –
   - Review the working papers for the relevant 5 years to assess the reliability of the audited accounts
   - Review accounting policies for appropriateness and consistency
   - Record for special consideration, any qualifications to report and any significant notes to the accounts.
5. Where necessary, make adjustments to the Statement of financial position and Income Statement. It is necessary to discuss any adjustments with the client and its auditors.
   Adjustments would be necessitated by:
   - Changes in Accounting policies
   - Fundamental errors
   - Changes in group structure
   - Material sources of revenue or categories of expenditure which are expected not to recur.
   - Extra-ordinary items.
6. The reporting Accountant should arrange to have access to:
   a. The statutory books including MEMART and minutes of Board meetings.
   b. Copies of any relevant reports e.g. feasibility reports, valuation reports etc prepared by outside consultants or internally.
   c. Tax computations and correspondences with FIRS.
7. The reporting accountant should arrange attendance at all parties meetings. This helps him to see that reasonable steps are taken to check the accuracy of figures, words and all relevant information and material facts.
8. He should arrange a tour of the company.

3.2.4 Content of Accountant's Report in a Prospectus: SEC requirement

1. Summarised Statement of Financial position of the last 5 years (3 years for SSM).

2. The full Statement of Financial position at the end of the last accounting year.

3. A Statement of Profit or Loss for the last 5 years (3 years for SSM).

4. The principal Accounting Policies used in preparing the report

5. Names and identities of the directors

6. Particulars of any share capital of the company

7. Particulars of all floatation costs

8. Particulars of any preliminary expenses incurred

9. The value of Land and Buildings, distinguishing between freehold and leasehold

10. Any surplus on the revaluation of fixed assets during the past 5 years

11. A valuation of all quoted and unquoted investments

12. A statement that no audited accounts have been made up to a period later than the Balance Sheet date.

3.2.5 Reporting Accountant's work on Financial Forecasts and Projections

Financial forecasts (statement of profit forecasts and working capital Adequacy) form an important part of the content of a prospectus. Profit forecast is an unpublished estimate of financial results relying on historical performance pattern and based on commercial assumptions. It is the directors' responsibility to prepare the financial forecasts. Generally the reporting accountant:

- Examines and reports on the accounting policies and calculations on the forecasts.
- Satisfies himself that the forecasts, so far as accounting policies and calculations are concerned have been properly compiled on the basis of the assumptions made.
- Does not report on the likelihood of the company achieving the financial forecasts but nonetheless ensures that unrealistic assumptions are not used for the report.

Main Points to consider in Reporting Accountant's Review

In carrying out his review, the main matters to which the reporting accountant will direct his attention are:

a) The nature and background of the company's business.
b) The accounting practices normally followed by the company.
c) The assumptions on which the forecasts are based; and
d) The procedures followed by the company for preparing forecasts.

Specifically, the reporting accountant's work programme on financial forecasts will involve:

1. Review of the nature and background of the company's business (if reporting accountant is different from the auditor). This will assist in understanding the assumptions and projections made by the client.
2. Obtain a statement of assumptions used by the company in the forecast.
3. Review of underlying assumptions and outline of the company's forecasting structure and method. Ensure there are no omissions and/or unrealistic assumptions.
4. Review of the accounting policies adopted and ensure they are consistent with those normally adopted by the company in preparing their annual accounts and with accounting standards.

5. Compare detailed results of the company for some years e.g past three years. Check the trend and assess the extent to which past forecasts align with actual results. This will give an indication on whether the current forecasts can be relied upon.
6. Compare forecast under review with any earlier forecast made in respect of the same overlapping period and obtain explanation for any material changes.
7. Make specific note where the achievement of the forecast is subject to a high degree of risk; for example, long-term contracts at fixed prices, businesses with difficult to predict sales levels, new or unproven products etc
8. Review of cash forecast and working capital adequacy, paying attention to following matters:
    i. Whether the assumptions used are the same as those used for profit forecast.
    ii. Whether the working capital forecast is adequate for forecast level of operations.
    iii. Whether items like investments, capital expenditure, taxation and dividends are included in the correct period.
    iv. Whether recently announced fiscal regulations/legislations are factored into the projections.
    v. Whether the pro-forma Statement of financial position at the end of the period reconciles with both profits and cash forecasts.
9. For a group:
    a) Check that the forecasts of subsidiaries have been correctly included in the consolidated forecasts. Test the arithmetical accuracy of the consolidated working papers.
    b) Ensure that detailed examinations have been made and letters of representation received, in respect of all subsidiaries or divisions which contribute materially to the forecast.
    c) Ensure that the results have been adjusted for intra-group transactions and unrealized profits.
10. Obtain written confirmation from bankers and other loan creditors (in appropriate cases) that facilities upon which forecasts are based will be available during the forecast period.
11. Ensure there are no threats to the going concern status of the company within the forecast period.

Note: It is important that the reporting accountant procures and files written assurances from management:

1. That the figures contained in the forecasts are based on the same accounting policies and principles as those applied in the audited annual accounts of the previous year.
2. That all items of exceptional or non-recurring nature have been disclosed either in the actual or forecast accounts or by report and comment thereon.
3. That management is at present time aware of no reason why the forecasts are unlikely to be achieved.

3.2.6 The Accountant's Report on Financial/Profit Forecasts

The report is addressed to the directors and the Issuing House.

The Accountant's report should include statements dealing with the following matters:

1. The fact that the reporting Accountant has carried out a review of the accounting bases and calculations on which the financial forecasts have been based.
2. Specific identification of the forecasts and documents to which the report refers.
3. A statement to the effect that the reporting accountant has not carried out an audit of estimated results for expired periods.
4. The fact that the directors are solely responsible for the forecasts.
5. Whether in the opinion of the reporting Accountant, the forecasts have been properly compiled on the basis of assumptions made by the directors, as set out in the circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

Note: If the reporting accountant has reason for material reservations about the accounting bases and assumptions/calculations for the forecasts, or if there are reasons to consider them inconsistent with stated assumptions or has not obtained all the information he considers necessary, he should qualify his report accordingly.

3.2.7 Matters Accountants should clear with the client before Accepting assignment as a Reporting Accountant.

Before accepting assignment as a Reporting Accountant, the Accountant should consider matters which might make it difficult or impossible for him to report on the forecasts. These matters include:

i. The insufficiency/inadequacy of time allowed for obtaining and assessing information required for the assignment.
ii. The nature of client's business activities: is its legality in doubt?
iii. The unreliability of the costing and accounting methods
iv. The unreliability of the forecasting methods
v. The reputation and credibility of the promoters: are these questionable?
vi. The need to obtain his consent to mention his name in the issue documents.
vii. Adequacy of time for reading the issue documents and checking all material facts and figures (particularly the 5-year financial summary).

3.2.8 Matters requiring clarification before commencement of Assignment

1. The purpose of the assignment
2. The scope of the assignment, that is, terms of reference
3. Period covered by the assignment
4. Agreement on the nature and responsibility for the accuracy of the forecasts; that is, that the assignment is of a non-statutory nature and the management is solely responsible for the accuracy of the forecasts.
5. Deadlines for reporting in view of sufficiency of time for comprehensive review.

6. Establish all restrictions beforehand.

4.0 Conclusion

Investigations require a higher level of assurance than conventional audit and therefore needs more care and skill in performing the assignment. There is no prescribed qualification for an investigator except in the case of the issue of a prospectus. Because his work and his expert report are central in any prospectus, he is statutorily required to be a chartered accountant in public practice. His work involves the review of both historical financial records as well as the financial forecasts presented in the prospectus.

5.0 Summary

In this unit, we compared investigation and conventional audit, outlined the classes of investigation and gave a synopsis of the stages involved in investigation. The unit finally dealt indepth with the reporting accountant's investigation duty on the issue of a prospectus.

6.0 Tutor-marked assignment

1. SINGEOBI Group is a large trading company made up of six subsidiaries. Due to the proposed expansion into export of Agricultural products, the need has arisen to raise more funds from the capital market. You have been appointed the reporting accountant to the ongoing issue of prospectus by the company. An "all parties" meeting has been scheduled to discuss the progress of the public offer.

Required:

a(i) Who is a reporting Accountant ? (1 mark)

(ii) Discuss the matters the reporting accountant should clear with the client before accepting assignment as a reporting Accountant. (5 marks)

b. Describe the Reporting Accountant's work programme for the review of financial forecaststo be included in the prospectus. (9 marks)

(Total: 15 marks)

2. You have been appointed the reporting accountant to the ongoing issue of prospectus by Sincere Group company. An "all parties" meeting has been scheduled to discuss the progress of the public offer.

Required:

a. Discuss the roles of the following principal parties in a public offer:
   i. The Reporting Accountant
   ii. The issuing house
   iii. The Registrar (9 marks)

b. Discuss the main points for consideration by the reporting Accountant during his review of the profit forecasts to be included in the prospectus. (6 marks)

(Total: 15 marks)

3. **Potential Ltd** is preparing for listing on the Emerging Market (SSM) segment of the Nigerian Stock Exchange. You have been appointed a Reporting Accountant with respect to the issue of a prospectus for this Initial Public Offer (IPO).

Required:

a. Outline the matters on which you will seek clarification from the company before commencing the assignment. (6 marks)

b. State the listing requirements of the Securities and Exchange Commission that should form part of the Accountant's report in the prospectus to be issued by this company. (9 marks)

(Total: 15 marks)

7.0 References/further reading

1. FGN, Companies and Allied Matters Act, cap C20 LFN 2004

2. Investment and Securities Act 2007

3. De Paula, F.C & Attwood, F.A(current), Auditing: Principles and Practice, 15th Edition, London: Pitman Publishing Ltd/ELBS.

4. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

UNIT 16: JOINT AND GROUP AUDITS

Content

1.0 Introduction

This unit focuses on joint and group audits. We discuss the need for joint audits as well as the advantages and disadvantages of carrying out joint audits. The unit also looks at group audits, its planning problems, challenges of using the work of other auditors while auditing the consolidation and the necessity to review the work of component auditors by the principal auditor.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the need for joint audits
- Describe the principles/ethical requirements for acceptance of nomination as a joint auditor
- Discuss the advantages and disadvantages of joint audits
- Discuss the planning problems of group audits
- Explain the risk areas that require audit attention when auditing the consolidation
- Explain the factors to consider when using the work of component auditors
- Explain why it is necessary to review the work of component auditors
- Discuss the necessary audit procedures for carrying out the review of the work of component auditors.

3.0 Main Content

3.1 Joint Audits

A joint audit is an assignment carried on the same financial statements at the same time by more than one audit firm.

3.1.1 Purposes/Need for Joint Audit

1. Management or shareholders may desire to have more than one assurance on the audit of the financial statements.
2. The operations of the company are large or complex that it will require the efforts of more than one firm to have an effective and timely audit.
3. Where shareholders believe that their interests are better served by having a joint audit. For example, in the case of MNCs with international auditors.

3.1.2 Ethical Requirements

i. On appointment as a joint auditor, the firm should communicate with all existing auditors.

ii. Where a joint audit is proposed as a sole audit, the surviving auditor should also communicate formally with the other auditor as though it is for a new appointment.

Principles Set Out For New Appointment

i. On proposal for appointment by a prospective client, the auditor should inform the client that he has a professional duty to communicate with the existing auditor.

ii. When asked to act, the proposed auditor should ask the client to inform the existing client of the proposed change and also obtain a written authority from the client to discuss the affairs of the company with the outgoing auditor.

iii. The proposed auditor should then write to the existing/outgoing auditor seeking information about the client and whether there are any professional reasons why he should not accept the audit.

iv. Where the client refuses to grant permission to discuss his affairs with the proposed auditor, the existing auditor should inform the prospective auditor of this fact and the proposed auditor should decline the appointment.

v. The existing auditor has a professional duty to answer expeditiously the communication/enquiry of the proposed auditor.

3.1.3 Joint Responsibilities/Liability

The joint auditors are joint liable for the audit assignment they undertake. Thus it is important that:

1. The terms of the assignment as a joint audit should be clear. One auditor should not do the accounting and the other the audit).
2. A meeting of the joint auditors and the client is important, to agree on the approach to the work and the responsibilities of the auditors, including timing and staffing.
3. The joint auditors should meet to agree on the division of work and should ensure all agreements as to work division are in writing and unambiguous.
4. Agreement is reached on exchange of working papers, so that each joint auditor will have a full set of working papers for each year's audit.
5. There is free exchange of information during and after the audit.
6. Periodic review of work progress by partners of the two audit firms should not be de-emphasized.
7. The use of the same audit programme by the joint auditors is encouraged to ensure that all aspects of the work are covered.
8. A joint work on some critical areas of the client's operations is carried out e.g. review of loans and advances of a bank.
9. Financial statements are jointly reviewed by the joint auditors before presentation to Audit Committee/.Management.
10. Both firms agree on the audit opinion and the content of the management letter.

3.1.4 Advantages of Joint Audits

1. Wide geographical coverage especially where client's operations are carried out through many branches.

2. Close co-operation between firms and this enhances diffusion of expertise.

3. Wider range of expertise is brought to bear on the assignment which likely leads to enhanced quality.
4. Added assurance to the client and users of financial information as report is signed by both firms.

5. Joint audits have been proposed as a way for 'mid tier' audit firms to break into the market of auditing large companies and groups, which at the moment is monopolised by the 'Big 4'. With close co-operation between firms, diffusion of expertise will be enhanced to meet the challenges and threat posed by the Big 4.

3.1.5 Disadvantages of Joint Audits

1. Joint liability means taking responsibility for the work of another firm.
2. It is likely to cost more to the auditee.
3. Requires a high standard of supervision and control to ensure completeness and good quality.
4. There may be problems for the two audit firms to work together harmoniously. The two audit firms may use very different audit approaches and terminology. This could make it difficult for the audit firms to work closely together, negating some of the efficiency and cost benefits discussed above. Problems could arise in deciding which firm's method to use, for example, to calculate materiality, design and pick samples for audit procedures, or evaluate controls within the accounting system.

3.2 Group Audit

A group consists of a parent company with either wholly and/or partly owned subsidiaries, associates(where the holding company can exercise significant over their affairs) and other related parties such as partnerships, joint ventures etc.

3.2.1 Audit Considerations

Note that the auditors (Group, Primary, principal or lead auditors) who sign the group audit report are responsible for all matters arising from the audit, even in respect of subsidiaries not audited by them.

Specific Planning Problems

Specific planning problems which the audit of group financial statement creates include:

1. Reviewing the respective size and locations of all operating units/components of the group.
2. Where the principal audit firm does not audit all the subsidiaries, the following issues do arise:

a. Quality control of audit work
b. The risk of material misstatements in works audited by other auditors
c. Arrangements for review of work completed
d. Timing and co-ordination of audit work.
e. Standardization of audit working papers.
f. Standardization of information to be sent to the principal/group auditors.

3. It is important that the group auditors audit a significant proportion of the group financial statements; otherwise they may not fully understand the business of the client and the likely risks that may arise during the audit.
4. The principal auditor should have knowledge of all group activities in order to be able to evaluate the risks of material misstatements arising in a subsidiary.
5. The lead auditor will need to consider management's arrangements for preparing the consolidated financial statements including:

a. Collection of data from subsidiaries
b. Group accounting instructions to ensure consistency of presentation
c. Group accounting timetable
d. Translation of financial information from overseas subsidiaries
e. Additional information requests from subsidiaries where local accounting regimes are not as comprehensive as those of the holding company.
f. Liaison with other audit firms, particularly overseas firms.
g. Staffing and budget issues

These arrangements will be reviewed by the holding company's auditors and incorporated in their planning. Also to be included in the principal auditor's planning are:

a. Audit staffing and mix that can satisfactorily carry out the audit strategy adopted;
b. Liaison with the auditors of the subsidiaries and associates; and
c. Anticipated special audit problems.

3.2.2 Auditing Investments in Subsidiaries and other Undertakings

Points for consideration include:

1. Obtaining evidence of the existence and ownership of the investments reflected in the holding company's books: inspection of share certificates/CSCS notes, dividends/interest

income streams, transaction evidence – ‘bought’ and ‘sold notes’, minutes of directors’ meetings etc.

2. Ensuring that the client has correctly accounted for the investments, especially when subsidiary is not wholly owned. Ensure appropriate accounting policies have been adopted and that the cost of control and non-controlling interests are properly determined.
3. Confirm the nature of the relationship with partnerships, joint ventures and related parties. Establish the question of any significant or controlling influence through board composition, funding arrangements, existence of guarantees and support arrangements, contractual arrangements etc.

3.2.3 Auditing the Consolidation

Issues which the principal auditors will need to address in addition to their work on the parent company’s financial statements include:

1. Co-terminus Accounting Periods: All the account consolidated should be made up to the same accounting reference date. Where the periods are not co-terminus, any difference in year ends should not exceed 3 months (IAS 27).
2. Accounting Policies: As far as possible, these should be consistent across the group. Where not possible, for example, in the case of overseas subsidiaries adopting a different accounting regime, consolidation adjustments may be required to effect the required consistent presentation. Where this is not possible, it will be necessary to disclose the departure from the group accounting policies, giving reasons for the inconsistency and quantification and explanation of the sums involved.
3. Consolidation Adjustments: The principal auditors should verify the consolidation adjustments, whether arising from acquisitions or as a result of inter-group trading. For example, adjustments arise from inconsistent accounting policies, elimination of unrealized inter-group profits, elimination of inter-group balances including adjustments for items in transit etc.
4. Loss making subsidiaries: The value of the investment in a loss making subsidiary should be carefully considered in both the Balance sheet of the parent company and the consolidation. A write-down of the investment and any goodwill arising on consolidation may be necessary. In addition, the holding company may need to guarantee the financial position of the subsidiary by means of Support letter or letter of comfort, stating that it will continue to support its subsidiary financially so that external creditors will be able to

be paid in full and that it will not demand repayment of inter-company loans or balances until all other creditors have been paid in full.

5. Acquisitions and Disposals of interests in Subsidiaries or related parties or companies: Auditors should ensure that all accounting rules and regulations that arise when there are changes in the composition of the group and their effects on the financial statements have been taken into consideration e.g. cessation of accounting for the component as a subsidiary or even matters relating to going concern considerations.
6. Any Restriction on paying Dividends: Auditors have to ensure the parent company has sufficient distributable reserves to pay dividends. Consideration will need to be given to the availability of profits from subsidiaries, particularly overseas subsidiaries.
7. Subsequent Events: Consideration of events occurring between Balance sheet date and date on which the accounts are signed is important. Appropriate disclosures may have to be made where subsidiaries have been acquired or disposed of in that period (non-adjusting events) or necessary adjustments made for all adjusting events e.g. the insolvency of a significant debtor, material write-down of stock values etc.

3.2.4 USING THE WORK OF ANOTHER AUDITOR (Ref. ISA 600/NSA 25)

1. **Acceptance as Principal Auditor**: The auditor should consider whether his own participation is sufficient to be able to act as a principal auditor. Thus, he has to evaluate whether the firm

    a. is competent to carry out the work;
    b. has sufficient knowledge of the business of the group and its components;
    c. audits a sufficient components of the group to enable the risk of material misstatement to be properly assessed; and
    d. will perform additional procedures regarding the components audited by the other auditors resulting in the principal auditor having significant participation in such audit.

2. As principal auditors, they will need to rely on the work of other auditors and that requires ensuring the professional competence of the other auditors. Some of the sources of information could be common membership of a professional body, affiliation with another firm or reference to the professional body to which the auditor belongs or even inquiries from other auditors, bankers etc.

In addition to the professional competence, the principal auditor needs to ensure that the other auditor:

- has available suitably competent staff,
- has the resources to carry out the audit of the subsidiary; and
- can deliver within time line.

Other considerations will include:

i. That there are no independence issues, either at subsidiary or group level and should obtain a written representation to that effect.
ii. That the subsidiary auditors are not aware of any specific group issues such as inter-group balances and transactions and related parties etc

3. The principal auditor should perform procedures to obtain sufficient appropriate evidence that the work of the other auditor is adequate for the principal auditor's purpose. In this regard, he would advise the other auditor of

- The use that is to be made of the other auditor's work and make appropriate arrangements for the coordination of their efforts at the initial planning stage of the audit;
- The accounting, auditing and reporting requirements and obtain written representations as to compliance with them

The principal auditor may review a written summary of the other auditors' procedures in the form of a consolidation questionnaire or completion memorandum or review working papers of the other auditor.

4 **Modified Auditors' Report**

The principal auditor has to consider any significant findings of the subsidiary auditors in the context of the group as a whole. Some items may be material at the subsidiary level but not at group level. Thus, any qualification at the subsidiary level may affect the group report only if the point in issue is material in the context of the consolidated accounts. E.g. A disclaimer at subsidiary level may be an 'except for' qualification in the group report. This will be a matter of professional judgment. But where the issue is material at subsidiary and group levels, the principal auditor should modify his report accordingly.

5. Foreign Subsidiaries

Key issues

i. The principal auditors need to consider whether there will be any difference in scope within the local audit and its equivalence in the country of residence of the parent company. If the local auditor has not carried out sufficient work, additional testing may be requested by the principal auditors.
ii. If IFRS has not been adopted in the resident country of the subsidiary, the local auditors may be employed to do so.
iii. Where the subsidiary is a material component of the group and the principal auditors have doubts about the standard and quality of either the financial

information produced by the subsidiary or the audit of that information or both, they may have to consider issuing a modified report.

iv. Accounting policies may differ from country to country and the principal auditors should be aware of the impact of any differences.

v. The effect and impact of foreign currency translations on the group results should be considered, particularly where the local currency is devaluing year on year against the parent country currency. For example, if the local currency exchange rate weakens substantially, an asset may appear to be declining in value, when in reality, its value has been maintained or even increased in local currency terms.

3.3 Review of Component Auditors' work by the Group/Main Auditor (Summary of 16.2.4)

Reasons for reviewing the work of other/component auditors

The main auditors are solely responsible to the members of the group for the audit opinion on the group accounts. It may be stated (in the notes on the accounts) that the financial statements of some of the subsidiaries are audited by other firms, but this does not absolve the main auditors from any of their responsibilities.

Since the main auditors have to report on the truth and fairness of the view given by the group financial statements, ISA 600 requires that the principal auditors review the audit of component units in order to satisfy themselves that, with the inclusion of figures not audited by them, the group accounts give a true and fair view. The Principal auditors need to examine the scope, standard, and independence of the work carried out by the component auditors as well as the competence of the engagement teams that did the work. The group auditors need to be satisfied that sufficient appropriate evidence has been obtained and that all material areas of the subsidiaries' financial statements have been audited satisfactorily and in a manner compatible with that of the group auditors themselves.

Principal Audit Procedures to carry out in performing such a review

(i) The Main auditor sends a questionnaire to the component auditors requesting detailed information on their work, including:

1. Compliance with the ethical requirements which are relevant to the group audit and in particular independence requirements.
2. An explanation of their general approach (in order to make a proper assessment of the standard of their work).
3. Details of the accounting policies of major subsidiaries (to ensure these are compatible within the group)
4. The component auditors' opinion of the subsidiaries' overall level of internal control, and the reliability of the accounting records.
5. Any limitations placed on the scope of the auditors' work.

6. Any modifications and the reasons for them, made or likely to be made to their audit reports.

(ii). Carry out a detailed review of the component auditors' working papers on each subsidiary whose results materially affect the view given by the group financial statements. This review will enable the group auditors to ascertain whether:

1. An up to date permanent file exists with details of the nature of the subsidiary's business, its staff organization, its accounting records, previous year's financial statements and copies of important legal documents
2. The systems examination has been properly completed. Documented and reported on to management after discussion
3. Tests of control and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed
4. All other working papers are comprehensive and explicit
5. The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit
6. The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards
7. Minutes of board and general meetings have been scrutinized and important matters noted
8. The audit work has been carried out in accordance with approved auditing standards
9. The audit work has been properly reviewed within the firm of auditors and any laid-down quality control procedures adhered to
10. Any points requiring discussion with the holding company's management have been noted and brought to the group auditors' attention (including any matters which might warrant a modification of the audit report on the subsidiary company's financial statements)
11. Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiaries' financial statements and those of the group.

If the group engagement partner is not satisfied as a result of the above review, he should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them.

4.0 Conclusion

The desire to have more assurance, meet reporting time line or protect the interest of some group of members may give rise to the need for joint audits. Joint audits, while enhancing the credibility of financial statements implies joint liability for the joint auditors and may result to increased cost to the clients. Group audits have its planning challenges due to many locations, different jurisdictions sometimes having different reporting frameworks and different auditors with different levels of competence and skills.This makes it imperative that the principal auditor may need to know the capability of each component auditor as well as do a review of the work they have carried out.

5.0 Summary

This unit considered the need for joint audits, its working principles and their advantages and disadvantages.We also discussed group audits as distinct from joint audits, its planning problems, the challenges of auditing the consolidation and audit procedures for reviewing the work of other auditors in the group.

6.0 Tutor-marked assignment

1. Singeobi Co is audited by Innocent Anyahuru & Co, a firm of Chartered Accountants. Angel Michael has enquired as to whether your firm, Ajaegbu & co, would be prepared to conduct a joint audit in cooperation with Innocent Anyahuru & Co, on the future financial statements of Singeobi Co if a proposed acquisition of MasterGoods Ltd goes ahead. Angel Michael thinks that this would enable your firm to improve group audit efficiency, without losing the cumulative experience that Innocent Anyahuru & Co has built up while acting as auditor to Singeobi Co.

Required:

Define ‘joint audit’, and assess the advantages and disadvantages of the audit of Singeobi Co being conducted on a ‘joint basis’**.** (8 marks)

2). You are the main auditor of Udeagbala Holdings, a listed company, which has subsidiaries in Nigeria and overseas, many of which are audited by other firms. All subsidiaries are involved in the manufacture and distribution of cosmetics and vegetable oil and have accounting periods coterminous with that of the holding company.

Required:

a. Explain why you would wish to review the work of the auditors of the subsidiaries not audited by you.
b. Discuss the audit procedures you will carry out while reviewing the work of subsidiary auditors.
c. Briefly discuss thepoints you will consider when auditing investments in these subsidiaries.
d. Discuss possible reasons and merits of conducting a joint audit for this group.

7.0 References/further reading

1. Millichamp, A.H & Taylor, J.R (2011)**.** Auditing, 11th Edition, London: BookPower/ELST
2. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.

UNIT 17: SPECIAL AUDITS

Content

1.0 Introduction

Some organizations– incorporated and unincorporated- operate and are regulated by laws and constitutions outside the companies and Allied Matters Act (CAMA) and/or in addition to CAMA. The auditor has to be familiar with the provisions of the relevant enabling Acts when auditing such organizations; otherwise, the auditing principles are the same for all audits.

Some of the special institutions/audits of interest include:

i. Banks
ii. Other Financial Institutions -Insurance companies, Primary Mortgage Institutions and Microfinance banks
iii. Clubs and Associations(including incorporated Trustees)
iv. Hospitals and Clinics
v. Hotels and restaurants
vi. Pension Funds
vii. MDAs including Corporations.

In this unit, we discuss two of such organizations, namely Banks and Insurance companies.

2.0 Objectives

By the end of his unit, you should be able to:

- Identify and explain the areas of special interest in the audit of banks
- Discuss the requirements of BOFIA for the accounting and audit of banks
- Explain and apply the loss provisioning guidelines stipulated by the Prudential guidelines

- Discuss the requirements of the Insurance Act regarding the accounting and audit of Insurance companies
- Explain the statutory provisions and reserves for both general business and life business
- Discuss the importance of the 'solvency margin' for insurance companies and demonstrate how to compute the margin.

3.0 Main Content

3.1 Audit of Banks

The operations, accounting and audit of banks fall under the following regulatory framework:

1. The CAMA, cap C20, LFN 2004 (as amended)
2. The CBN Act 2004 (as amended)
3. The Banks and Other Financial Institutions Act (BOFIA)1991 as amended
4. The Prudential Guidelines(as updated till date)
5. The CBN monetary Circulars – issued from time to time; more often on yearly basis
6. The NDIC Act 1988 as amended

For the effective audit of banks, the auditor should be knowledgeable about, and familiar with the current provisions of the above Acts, Guideline and Standard.

3.1.1 CBN Act and BOFIA

The provisions of these Acts regarding the operations of banks include such vital issues as –

1. Minimum Paid-Up Share Capital requirements
2. Capital Adequacy ratio
3. Minimum holding of cash reserves, specified liquid assets including special deposits.
4. Returns to be rendered to CBN – mid-month, monthly, quarterly etc.
5. Power of CBN to conduct routine and special examinations or investigation of the books and affairs of the banks.
6. Power of CBN to assume management of ailing banks
7. Power of CBN to revoke or vary conditions for licences of banks
8. Maintenance of Reserve funds etc

Areas of audit attention should thus include:

1. The Capital base: There is the need to confirm that the bank has met the minimum capital requirement as stipulated by CBN (currently put at N25billion)
2. Statutory Reserves: A confirmation of the bank's compliance with the statutory reserves stipulated by BOFIA and Monetary circulars.
3. Internal Control: It is important to review controls put in place by management, especially over foreign exchange, loans and advances, cash and other tangible assets.
4. Loans and Advances portfolio: To review and confirm the income earning asset quality, ensuring that the loans are adequately secured and that adequate loan loss provisions are made in accordance with regulations/guidelines.

5. CBN/NDIC Rules and Regulations: A confirmation that the bank is operating within the ambits of CBN rules, guidelines and regulations and that required premium had been paid to NDIC in respect of insured deposits.
6. Accounting system: A review of accounting system is necessary to ensure adequacy for banking operations.
7. Liquidity: The ability of the bank to meet its current obligations as at when due is pivotal to its continued existence. Auditor needs to confirm that the bank's liquidity position is adequate for its operations and that enough liquid assets are available.
8. Going Concern status: In this regard, the auditor needs to review the quality of management, adequacy of working capital, quality of assets and income including deposit liabilities and risk assets.
9. Branch networks: Review network of branches and their locations with a view of paying visits, and for unvisited branches, review returns from them for reasonableness and completeness.
10. Assets Valuation: Review the valuation of bank assets and confirm whether adequate provisions have been made for any permanent diminution in their values.

3.1.2 BOFIA and Accounting and Audit of Banks

Some provisions of BOFIA deal specifically with the books of accounts and the audit of banks. These include:

S.24(1) Every bank shall cause to be kept proper books of accounts with respect to all the transactions of the bank.

S.24(4) - Gives the CBN the power to appoint qualified accountants to prepare proper accounts or render proper returns(at the bank's expense), if the CBN is not satisfied with the accounts kept by the bank or with the returns rendered by it.

S.25 - Specifies the returns to be rendered by banks to CBN on monthly basis. The requirements of these returns may be reviewed from time to time through the Monetary Policy Circulars but usually include monthly statements showing:

- The assets and liabilities of the bank
- An analysis of Advances and other assets
- Profit and loss account
- Such other information, documents and statistics which CBN deems necessary for the proper understanding of the statements.

S.26 – Empowers CBN to prepare and publish consolidated statements aggregating the statements furnished under S.25 for each category of banks.

S.27 – Not later than 4 months after its financial year end, every bank shall publish, subject to approval by CBN, its Balance Sheet and Profit and Loss a/c, duly signed and containing the full and correct names of the directors of the bank. Every published financial statement must disclose any contraventions of BOFIA and penalties paid for such contraventions. Auditors' report shall specify such contraventions.

S.28 – Specifies the contents and form of accounts. They shall give a true and fair view of the state of affairs of the bank as at the end of the reporting period and shall comply with the requirements of any circular which has been issued by the CBN.
S.29 – Deals with the appointment, power and report of "approved Auditor". Every auditor of a bank shall be –

- ❖ A member of a professional accountancy body recognized in Nigeria
- ❖ Approved by CBN
- ❖ Carrying on in Nigeria professional practice as accountant and auditor.

By S.29 (7), if an approved Auditor, in the course of his duties as an auditor of a bank is satisfied that –

- There has been a contravention of BOFIA, or that an offence under any other law has been committed by the bank or any other person; or
- Losses have been incurred by the bank which substantially reduce its capital funds; or
- Any irregularity which jeopardizes the interest of depositors or creditors of the bank or any other irregularity has occurred; or
- He is unable to confirm that the claims of depositors or creditors are covered by the assets of the bank; he shall immediately report the matter to CBN.

S.29(8) – The Approved Auditor shall forward to the bank(CBN) **two** copies of the domestic report on the (client) bank's activities not later than **3 months** after the end of the bank's financial year.

3.1.3 NDIC and Banks Deposit Insurance

By the NDIC Act, the banks are mandated to insure their total deposit liabilities (Current, savings and Deposit account balances less deposits held in Collaterals) with the NDIC. The premium payable per annum is 15/16 of 1% of total assessable deposit liabilities standing in the books as at 31 December of the preceding year.

3.1.4 BOFIAand Prudential Guidelines on Bank Audit

The standard and BOFIA give guidelines with regard to:

- Income recognition
- Loss recognition
- Balance Sheet classification
- Disclosure requirements.

Income Recognition

Income sources of banks include interest on loans and advances, COT, transfer fees, commitment fees, syndication fees, arrangement fees, lease rentals, income from sale of CPs, Forex, BAs and discount of bills etc.

Loss Recognition

Risk assets (Loans and Advances) are to be classified as performing and non-performing. An Advance is non-performing if principal or interest due remains unpaid for 90 days or more.

According to BOFIA Non-performing loans and Advances should be re-classified into three categories, namely: Substandard, doubtful or lost based on the following criteria:

a) **Sub-standard facilities**
i) Objective criteria: Facilities on which unpaid principal or interest remain outstanding for more than 90 days but less than 180 days.

ii) Subjective Criteria: Credit facilities which display well defined weaknesses which could affect the ability of borrowers to repay such as inadequate cash flow to service debt, undercapitalization or insufficient working capital, absence of adequate financial information or collateral documentation, irregular payment of principal and/or interest, or inactive accounts where withdrawals exceed repayments or where repayments can hardly cover interest charges.

b) **Doubtful facilities**
i) Objective Criteria: facilities on which unpaid principal and/or interest remain outstanding for at least 180 days but less than 360 days and are not secured by legal title to leased assets or perfected realizable collateral in the process of collection or realization.
ii) Subjective Criteria: facilities which, in addition to the weaknesses associated with sub-standard credit facilities reflect that full repayment of debt is not certain or that realizable collateral values will be insufficient to cover bank's exposure.

c) Lost Credit facilities
i) Objective Criteria: facilities on which unpaid principal and/or interest remain outstanding for 360 days or more and are not secured by legal title to leased assets or perfected realizable collateral in the course of collection or realization.

ii) Subjective Criteria: facilities which in addition to the weaknesses associated with doubtful credit facilities, are considered uncollectible and are of such little value that continuation as a bankable asset is unrealistic such as facilities that have been abandoned, facilities secured with unmarketable and unrealizable securities and facilities extended to judgment debtors with no means of foreclosable collateral to settle debts.

Loss provision Requirements are as follows:

i. Interest overdue by more than 90 days (or shorter period as regulatory authorities may specify): Suspend such interest and recognize income on cash basis.
ii. Principal repayment overdue by more than 120 days (or shorter period as regulatory authorities may specify): Make full provision and recognize recoveries on cash basis.
iii. When principal repayments are subject to provision, it should be made as follows:

No. of days principal and /or Interest is overdue	Classification	Min. % provision for Principal not due
Greater than 90 days but less than 180 days	Substandard	10%
Greater than 180 days but less than 360 days	Doubtful	50%
Greater than 360 days (and not secured)	Lost	100%

The standard also recommends a general provision of at least 1% of risk assets not specifically provided for, in addition to the specific provisions, to provide against as yet unidentified losses which are inherent in any portfolio.

Note:

1. .Where the facility is secured by a perfected fixed legal charge over, or by title to, tangible property, the principal provisioning could cease once the outstanding principal is less than a specified proportion of the estimated net realisable value of the security as follows:

   i. Where the principal repayment is overdue by more than one year, the outstanding un-provided principal should not exceed 50% of the estimated net realisable value of the security.

   ii Where the principal repayment is overdue by more than two years, there should be no outstanding un-provided portion of the credit facility irrespective of the estimated net realisable value of security held.

   iii In both (i) and (ii) above, where regulatory authorities stipulate shorter periods or lower percentages, such shorter periods or lower percentages should be followed.

2. Where a facility is secured by a floating charge or an unperfected or equitable charge over tangible property, it should be treated as an unsecured credit and no account taken of any security held in determining the provision for loan loss.

REVOLVING AND OVERDRAFT FACILITIES

Normally the first indication that a revolving or overdraft facility may be non-performing is when the turnover on the account is considerably lower than anticipated when the facility was arranged or when interest is charged which takes the facility above its credit limit.

In these circumstances:

[a] A revolving facility should be classified as non-performing and unpaid interest suspended once 90 days (or shorter period as may be specified by regulatory authorities) elapses after the facility limit is exceeded.

[b] Where credit limits are not exceeded, each bank should have a systematic method for the identification of non-performing revolving credits. Once classified as non-performing, all unpaid interest on the facility should be suspended.

[c] Once a facility is classified as non-performing, provision against principal and unpaid interest should be made in accordance with a systematic method to reduce the outstanding principal to the estimated net realisable value of any security held over a specified period.

Investments in Securities

1. Long term investments in marketable securities should be stated at the lower of cost and net realizable value. The market value should be disclosed.
2. Short term investments in marketable securities should be stated at net realizable value. The original cost should be disclosed.
3. Investments in securities for which there is no active market should be stated at the lower of cost and net realizable value.

Disclosures

In addition to other disclosure requirements of relevant accounting standards, banks should also disclose:

1. **Accounting Policies** – Statement of Accounting policies to include –
   a. A brief description of the systematic method by which non-performing loans are identified and the method by which loan loss provisions are determined.
   b. The nature of Off-balance sheet engagements and the methods used to recognize income thereon.

2. **Income Statement –** Each principal revenue item should be stated separately in the financial statements.

The disclosure in the income statement and the notes to the financial statements should include, but are not limited to, the following income and expense captions:

INCOME

- Interest and discount income
- Lease finance income
- Fees for services rendered
- Foreign exchange income
- Commission income
- Income from investments

EXPENSES

- Interest expense
- Loan loss expense, showing separately any release of provisions previously made
- Commissions paid
- Foreign exchange losses
- General and administrative expenses
- Diminution in asset values

The following items should be disclosed in the financial statements

a. Interest income split between bank and non-bank sources

b. Interest expense split between bank and non-bank sources

c. Credit related fee income and expenses where such fees are recognized at once (that is, not amortized or deferred)

A bank should not offset one item of revenue or expense by deducting from it another item of revenue or expense.

3. **Balance Sheet (Statement of Financial position)** - Assets and liabilities should be grouped according to their nature and be listed in order of liquidity. The disclosures in the balance sheet and the notes to the financial statements should include but are not limited to the following assets and liabilities.

ASSETS

- cash and short-term funds
- Due from other banks
- Bills discounted
- Investments
- Loans and advances
- Advances under finance leases
- Other assets
- Fixed assets (non-current assets)

LIABILITIES

- Deposits and current accounts
- Due to other banks
- Taxation payable

- Divided payable
- Other liabilities
- Long term loans
- Shareholders funds

4. Maturity Profile of Risk Assets and Deposit liabilities

The profile should be given in the following categories -

Under	-	1 month
1 month	-	3 months
3 months	-	6 months
6 months	-	12 months
Over	-	12 months

The above maturity profile should be based on the expected normal repayment periods of the assets and liabilities.

5. Loan Losses

The amount of provision for loan losses, segregated between principal and interest, should be disclosed and deducted from the relevant asset category. Provision for losses of off balance sheet engagements should be shown separately as a component of other liabilities. An analysis of the movement in the various categories of loan loss provision should be disclosed.

One item of asset or liability should not offset by deducting another asset or liability unless a legal right of set-off exists.

6. Loans and Advances

An analysis of Loans and Advances between performing and non-performing loans should be disclosed.

7. Off-Balance Sheet (Statement of financial position) Engagements and Contingencies

Certain transactions are not currently recognised as assets or liabilities in the balance sheet but nonetheless give rise to credit risks, contingencies and commitments. Such transactions include letters of credit, bonds, guarantees, indemnities, acceptances, trade related contingencies such as documentary credits, etc. These types of transactions are referred to as “Off Balance Sheet(Statement of Financial position) Engagements”.

The nature and amount of contingencies and commitments arising from different classes of off balance sheet engagements should be disclosed by way of notes on the accounts. Their disclosure in note form should distinguish between:

[a] direct credit substitutes, such as guarantees, acceptances and standby letter of credit serving as guarantees;

[b] transaction-related contingencies, such as bid bonds, performance guarantees and standby letters of credit related to particular transaction;

[c] short term self liquidating trade-related contingencies resulting from the movement of good, and

[d] other contingencies

8. **Other Assets and Liabilities**
   Major items that make up "Other Asset" and "Other Liabilities" should be shown in the notes on the accounts.

3.1.5 Provisions of Schedules 4 and 5 of BOFIA

Schedule 4 of BOFIA specifies matters to be expressly stated in the Approved Auditor's Report. These are:

1. Whether proper books of account have been maintained at the bank's head office and at each of the bank's branches in such a way as to give a true and fair view of the bank's transactions.

2. Whether the auditors have examined the books of account at the bank's head office and at each of the bank's branches and whether adequate returns have been received from branches not visited.

3. Whether the auditors have obtained information and explanations considered necessary for audit purpose.

4. Whether in the opinion of the auditors, the bank's assets have been properly valued and whether adequate provisions have been made for diminution in assets' values.

5. Whether to the best of the knowledge of the auditors, the bank has contravened the provisions of BOFIA and the guidelines issued by CBN and NDIC, and where relevant, the Nigeria Stock Exchange. Where there have been contraventions, the auditors should state whether the associated penalties have been paid.

6. Whether in the opinion of the auditors, the financial statements of the bank give a true and fair view of the state of affairs of the bank at the balance sheet date and of the profit or loss and statement of cash flows for the relevant year end.

Schedule 5 requires the analysis of the loans and advances portfolio into:

1. Loans and advances not wholly recoverable due to insufficient efforts by the bank.

2. Loans and advances that are partly or wholly irrecoverable due to the poor financial position of the debtor.

3. Others – which may be classified into loans to –

   i. Deceased persons

ii. Companies in liquidation or already liquidated

iv. Bankrupt individuals

The schedule requires that the following information be given on loans of doubtful value:

i. The original amount advanced

ii. The date loan was advanced

iii. The interest rate

iv. The date of last repayment

v. Balance outstanding, distinguishing between the principal and interest.

vi. Efforts made by the bank to recover the loan

vii The realizable value of the collateral used as security

viii Estimate of bad and doubtful debts.

Self-assessment questions

1. Enumerate the provisions of schedule 4 of the Banks and Other Financial Institutions Act (BOFIA) 1991.

2. Section 29(7) of BOFIA requires the Approved Auditor to report to CBN when he is not satisfied over certain matters in the affairs of the client bank. State such matters.

3.2 Audit of Insurance Companies

3.2.1 Overview

The operations, accounting and audit of insurance companies must conform to the following legal and regulatory frameworks viz.

1. CAMA, cap C20 LFN 2004.
2. The Insurance Act 2003
3. IFRS 4 *Insurance Contracts*
4. Relevant circulars issued by NAICOM.

The Insurance business is broadly divided into two main classes:

a. Life insurance business
b. General insurance business

Life business is subdivided into 3 categories, with corresponding fund accounts required to be maintained namely:

- ❖ Individual life assurance business
- ❖ Group life insurance business and
- ❖ Health insurance business.

General insurance business is subdivided into 8 categories:

- ❖ Fire insurance
- ❖ General accident insurance
- ❖ Motor vehicle insurance
- ❖ Marine and Aviation insurance
- ❖ Oil and Gas insurance
- ❖ Engineering insurance
- ❖ Bonds, credit guarantee and surety insurance business; and
- ❖ Miscellaneous insurance business.

3.2.2 Areas of Audit Importance/Emphasis

Minimum Paid Up capital

The minimum paid up capital requirement for the different classes of insurance business are as follows:

a. Life Insurance Business: not less than =N=150million, presently fixed at =N=2bn.
b. General Business: not less than =N=200million, currently fixed at =N=3bn
c. Composite Insurance Business: not less than =N=350million, currently fixed at =N=5bn
d. Re-Insurance Business: not less than =N350million, currently =N=10bn.

Statutory Deposit

By s.10 of the Insurance Act, every intending insurance company should make a "statutory Deposit" of 50% of the paid up capital with the CBN. Sixty (60) days after registration of the insurer, 80% of this deposit is released with interest. Existing companies are required to maintain a statutory deposit of 10% of their paid-up share capital with CBN. Any withdrawal from the deposit shall be made good within 30 days, failing which the insurer may be suspended from business.

Separation of Accounts and Maintenance of Reserve Funds

Where an insurer carries on the two classes of 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.

Required Provisions and Reserves for General insurance business are:

Unexpired Risks

An insurer in non-life (i.e. general) business shall maintain for each class of insurance business a provision for unexpired risks which shall be calculated on a time apportionment basis of the risks accepted in the year. There is the possibility of the covered risk attracting full liability on a future date; thus, just as the company carries forward premiums which relate to future periods as "unearned premiums", provision needs to be made in the accounts to meet full claims for businesses still in force after the accounting period.

It is the duty of the company to determine the method of assessing and making provision for unexpired risks. The auditor ensures the adequacy and reasonableness of the provision as well as the consistency of method adopted in making the provision.

Outstanding Claims

Provision for outstanding claims shall be credited with an amount equal to the total estimated amount of outstanding claims plus 10% of the estimated figure for claims incurred but not reported at the end of year under review [s.20(1b)].

Usually, provision made for outstanding claims are in respect of –

- Claims notified and agreed: this is normally made up of the amount of the claims plus claims handling expenses;
- Claims notified but not agreed: provision will be the best estimate by management plus estimated amount of claims handling expenses; and
- Claims incurred but not notified/reported: this is based on the experience of management relating to such business.

The auditor should satisfy himself that a consistent, reasonable and acceptable method has been adopted in making the provisions. A change in method with any material effects on the financial statements will need to be disclosed.

Contingency Reserve

This reserve is established and maintained to cover fluctuations in securities and variation in statistical estimates. This reserve account is to be credited with an amount not less than 3% of total premium or 20% of net profits, whichever is greater. This is accumulated until it is equal to the minimum paid up capital or 50% of net premiums whichever is greater.

For life business, there shall be maintained:

General Reserve Fund: To be credited with an amount equal to the net liabilities on policies in force at the time of actuarial valuation plus 25% of net premiums for every year between valuation dates; and

Contingency Reserve Fund: To be credited with an amount equal to 1% of gross premiums or 10% of the profits whichever is greater and accumulated until it is equal to the minimum paid-up capital.

A re-insurer shall create a General Reserve Fund which shall be credited with an amount –

a. Not less than 50% of the gross profit for the year, where the fund is less than the authorized share capital of the insurer
b. Not less than 25% of re-insurer's gross profit for the year if the fund is equal to or exceeds the authorised capital of the re-insurer.

Claims

Claims are amounts payable under a contract of insurance on the occurrence of the insured event. Claims handling expenses, direct or indirect, are usually incurred on the process of investigating or settling claims. The auditor should ensure the inclusion of all claims handling expenses in the determination of the amount of claims. This ensures that each revenue account is charged with all expenses related to the claims incurred. Care should be taken to ensure that handling expenses are charged in the same period with the related claims.

Solvency Margin

For general business, a solvency margin is required to be maintained. The solvency margin is calculated as the excess of the value of the insurer's *admissible assets* in Nigeria over its liabilities in Nigeria consisting of –

a. Provisions for unexpired risks;
b. Provision for outstanding claims;
c. Provision for claims incurred but not yet reported; and

d. funds to meet other liabilities.

The solvency margin shall not be less than 15% of the gross premium income less reinsurance premiums paid out during the year under review or the min. paid-up capital whichever is greater.

The Auditor is required to issue a certification stating the extent to which the insurer has satisfied the solvency margin. Where an auditor issues a false certification, NAICOM may report the auditor to the appropriate professional body for disciplinary action. In the event that the insurer becomes insolvent after certification, any auditor or official of the commission who in the previous 3 years had certified the company as being solvent shall be held liable.

Note: Admissible assets consist of –

a. Cash and bank balance
b. Quoted investments at market value
c. Unquoted stock at cost;
d. Land and buildings;
e. Furniture and fittings;
f. office equipment;
g. Motor vehicles;
h. Prepaid expenses to members of staff;
i. Amount due from retrocession
j. Staff loans and Advances; and claims receivable

Investments

Insurance companies shall have investments of not less than the amount of the policy holders' funds which shall be invested in the following areas:

a. Shares of limited liability companies;
b. Shares in registered co-operative societies;
c. Loans to building societies approved by the commission;
d. Loan on real property, machinery and plant in Nigeria;
e. Loans on Life Policies within their surrender values;
f. Cash deposit in or bills of exchange accepted by licenced banks;
g. Such other investments that may be prescribed by NAICOM.

The auditor should ensure that investment expenses (i.e. cost of buying and selling investments) are matched with the related income from investments and in the correct period.

Note: Not more than 35% of the insurance company's investments should be in real property.

Determination of Life Insurance Profits

The profit of a life business is determined only by actuarial valuation of the liabilities and comparing this by available assets. Valuation may be made whenever bonuses (dividends) are to be distributed but at least once every 3 years.

The method of actuarial valuation is as follows:

i. Determine the PV of the company's total liabilities on all current policies in respect of
    - Sum assured and
    - Bonuses already declared
ii. Determine the present value of the total premiums receivable by the company under existing policies less expenses.
iii. Deduct (ii) from (i) above. The result is the net liability on all policies.
iv. Deduct the net liability (iii above) from total life fund as per the last Balance sheet (i.e. statement of financial position). The difference, if positive, is the surplus on the life fund to be credited to the income account; if negative it is charged to income account.

Statement of Accounts

Not later than 31st March of each year, the insurance company shall submit to NAICOM

a. A duly audited Balance Sheet together with a copy of the relevant Income statement which the insurer will present to its shareholders at the AGM.
b. A Revenue account for each class of insurance business the company undertakes
c. A statement of investments representing the insurance funds.

The auditor should ensure compliance with this provision.

4.0 Conclusion

Banks and Insurance companies are regulated institutions and their operations and financial reporting must comply with the regulatory framework. The audit objective in this regard is to ensure compliance with laws and regulations governing these institutions.

5.0 Summary

This unit looked at the audit of banks and insurance companies. Areas of special audit interest are identified and the peculiar accounting and reporting needs of the institutions were emphasized. These include loss provisioning requirements for banks and special statutory reserves and provisions in the case of insurance companies.

6.0 Tutor-marked assignment

1. As the audit senior in the audit of GoodHealth Bank Plc for the year ended 31 December, 2012, you have been assigned to review the loan portfolio of the bank. A scrutiny of the records reveal that the bank has a loan portfolio of =N=950million, 5% of which is serviced as at when due. Of the balance, 40% is outstanding for 260 days, 30% has been outstanding for 140 days and the remaining 30% has been outstanding for 15 months. The bank made a provision of =N=270 million in conformity with the prudential guidelines.

Required

i. As stipulated in the Prudential Guidelines, what are the objective criteria for classifying loans and advances into
   a. Performing
   b. Substandard
   c. Doubtful; and
   d. Lost

(6 marks)

ii. Verify the accuracy of the provisions made by GoodHealth Bank Plc for the year ended 31 December, 2012).

(9 marks)

(Total 15 marks)

2. In the audit of Insurance companies, it is important that the independent auditor pays particular attention to all statutory and regulatory frameworks governing the industry.

Required:

Discuss the independent auditor's duties in respect of the following areas of an insurance company's financial statements:

i. **General Business**

a. Outstanding claims. (3 marks)
b. Solvency margin (4 marks)

ii**. Life Business**

a. Maintenance of Contingency Reserve Fund (2 marks)
b. Maintenance of General Reserve Fund (2 marks)
c. Determination of life insurance profits (4 marks)

(Total 15 marks)

7.0 References/further reading

1.Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended)

2. Prudential Guidelines (as updated till date)

3. CBN Act 2004 (as amended)

4. The Insurance Act 2003 Plus NAICOM guidelines.

5. NDIC Act 1988 as amended.

6.The CBN monetary Circulars – issued from time to time

6. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

UNIT 18: SPECIAL AUDITS PART II - PUBLIC SECTOR AUDIT

Content

1.0 Introduction

In this unit, continue our study on special audits. Our focus is on the public sector. The unit surveys the legal and regulatory framework for the public sector audit and considers the accounting and audit of treasury accounts, MDAs and some parastatals. The duties and responsibilities of the internal audit function are discussed as well as the concept, elements and techniques of Value-for-money audits.

2.0 Objectives

By the end of this unit, you should be able to:

- Discuss the Constitutional provisions for the establishment of the Office of the Auditor-General for the Federation (OAGF) and the functions of the Auditor-General
- Explain the objectives of auditing the treasury accounts, the ministries, departments and agencies (MDAs)
- Describe the duties and responsibilities of the internal audit department
- Explain Self-accounting, non-self-accounting and sub-accounting units and the requirements for the establishment of such units
- Outline the audit procedures for verifying revenue, Vote book, project accounts, cash book and document register.

- Define ‘value-for-money’ (VFM) audit and explain the elements of value-for-money audit.
- Outline the techniques of VFM audit.
- Discuss the problems associated with the audit of teaching hospitals.

3.0 Main Content

3.1 Regulatory/Legal framework

1. The constitution of the Federal Republic of Nigeria
2. Finance (Control and Management Act, Ca. F.26 LFN 2004
3. The Act or Edict setting up a particular parastatal, corporation or Agency
4. The Financial regulations (revised)
5. The Public procurement (Due process) Act 2007
6. The Pension reform Act (for Pension Audit) 2014

Sect.85, 1999 constitution(as amended) establishes the Office of the Auditor-General for the Federation with a primary role of ensuring that there is accountability by the executive arm of Government and for the proper administration of the activities, functions , operations and programmes of the government and its agencies. However, the Constitution prohibits the Auditor-General from auditing the accounts of “government statutory corporations, commissions, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.” These are audited by external auditors (Public accountants), but the Office can undertake periodic checks in such state owned entities.

Sect. 85 of the Constitution requires that the Auditor-General shall, within **ninety (90) days** of receipt of the Accountant-General’s financial statements, submit his reports to each House of the National Assembly, which shall cause their respective Public Accounts Committees to consider the reports.

Thus, the institutional arrangements make the Auditor- General for the Federation responsible for auditing the accounts of the Federal Government and reporting to the National Assembly. The Public Accounts Committee (PAC), a committee of the National Assembly is responsible for the public accounts in accordance with sect 85 (5) of the Constitution. The PAC deliberates on the Auditor-general’s report, considers all queries raised by him in his report and makes a report, including its recommendations, to the whole House.

Similar arrangement exists at the state level where there are State Auditors-General and Auditors-General for local governments. Currently, there are 73 Auditors-General in Nigeria.

Auditor- General for the Federation

Appointment

Sect. 86, 1999 constitution provides that the Auditor-General for the Federation shall be appointed by the President on the recommendation of the Federal Civil Service Commission, subject to confirmation by the Senate.

Roles and Powers

The Auditor- General:

- Shall audit the accounts of all accounting officers and of all persons entrusted with the collection, receipt, custody, issue, sale, transfer or delivery of any stamps, securities, stores or other property of the Government of the Federation.
- Is responsible for carrying out surveys of the cash, stamps, securities, stores or other properties of government that are held by such officers or persons.
- Shall ascertain whether the objectives of government auditing are met; and in this regard shall state whether in his opinion:
    a. The accounts relating to public funds have been properly kept;
    b. All public monies have been fully accounted for and the rules and procedures applied are sufficient to secure effective check on the assessment, collection and proper allocation of revenue;
    c. Essential records have been maintained and the rules and procedures applied are adequate to safeguard and control public property and funds;
    d. Monies have been expended for the purposes for which they were appropriated and expenditures have been made as authorized.
- Shall sanction any erring officer
- Shall alert the President of any audit alarm of importance and serious audit queries for which the accounting officer is liable.
- May undertake the examination of the accounts of any organization that receives funds from the government such as statutory corporations, parastatals and voluntary agencies.

Functions

The AGF's functions include:

- Auditing and reporting in respect of treasury accounts, accounts of ministries/extra-ministerial departments and accounts of parastatals;
- Detection and prevention of fraud;
- Control of loss of funds by ensuring that effective control systems are in place;
- Serving as the chairman of the audit alarm committee and the chairman of the Lsses committee.
- Attending the PAC sessions as an adviser.

Public sector auditing fall into three major categories viz.:

- Audit of Treasury Accounts
- Audit of MDAs
- Audit of accounts of Parastatals.

Audit of Treasury Accounts

The treasury Department is headed by the Accountant-General of the Federation (the chief Accounting Officer of the Federation). He also serves as the treasurer and the financial Adviser of the Federal Government.

Functions of the Treasury Department

a. It takes custody of and manages the CRF, the Development Fund, the Contingency Fund and other public funds of the Federation;
b. It keeps records of the financial transactions of the government and reports thereon.
c. It manages the Federation accounts and their disbursement to the 3 tiers of government
d. It supervises the accounts of ministries and extra-ministerial departments and instructs them through circulars on government accounting and financial control matters.
e. It initiates and formulates financial and accounting policies for the Federal Government.
f. Responsible for training and development of accounting and auditing personnel from the three tiers of government
g. Responsible for revenue monitoring

Objectives of Treasury Accounts Audits

To ascertain whether:

i. The financial statements have been prepared in accordance with generally accepted government accounting principles; and
ii. The information contained in the financial statements are properly classified, reliable, accurate and complete.

Accountant-General's financial statements

The Accountant-General's financial statements consist of eleven main financial statements and 25 supporting and sub-supporting statements. The 11 main financial statements are:

Statement no.	Description of Statement
1	Public debt
2.	Assets and Liabilities
3.	Consolidated Revenue fund
4.	Development Fund
5.	Treasury Funds
6.	Special and Trust Funds
7.	Other loans and Investments
8.	Losses of government Funds and Stores
9.	Revenue Abandoned during year
10.	Guarantees of the Federal Government of loans to statutory Corporations etc
11.	Arrears of Revenue as at the end of the year.

Self-assessment Question

1. Describe the objectives of Treasury accounts audit.

2. Discuss the roles and powers of the Auditor-general with regard to the audit of government accounts.

3.2 Audit of Ministries, Departments and Agencies

Objectives

The main objectives of auditing Ministries, Departments and Agencies include ascertaining whether:

- All receipts of money emanating from the operations of the period under review are collected and properly accounted for;
- The accounting system provides information that is reliable and free from material errors to facilitate the preparation of the financial statements required by law;
- The activities and programmes of the MDA's are conducted and expenditure made in an effective, efficient and economical manner and in compliance with the requirements of the applicable laws and regulations;
- The Ministry, department or Agency being audited is carrying out only those activities and programmes authorized by the National Assembly in a manner that will accomplish the objectives intended;
- The resources of the MDAs are adequately controlled and utilized in an effective, efficient and economical manner; and
- The accounting and financial statements presented to the authorities (i.e. the AGF) properly disclose the information required by both internal and external users.

Accounting Units

For the purpose of Accounting and audit, each Ministry or Extra-Ministerial department is regarded as an accounting unit.

Accounting Units are classified into

- Self-Accounting units;
- Non-self Accounting units; and
- Sub-Accounting Units.

Self-Accounting Units

These are Ministries or extra-ministerial departments where the accounting functions are delegated to the accounting officer (i.e. the Permanent secretary or Head of department, respectively.

Self –Accounting units are required to be:

- ✓ Approved by the Ministry of Finance to be a self-accounting unit
- ✓ Write an Accounting Manuel or Code which must be approved by the Accountant-General and Auditor-general
- ✓ Establish an Internal Audit Department
- ✓ Operate a central pay office and
- ✓ Operate two current accounts with CBN – one for Revenue account and the other for capital expenditure.

A self- accounting unit submits the following documents to the Accountant-General of the Federation:

- ✓ A monthly transcript
- ✓ Voucher schedules
- ✓ Duplicate copies of vouchers
- ✓ Duplicate copies of vouchers relating to other ministries;
- ✓ Certificate of cash and bank balances
- ✓ Bank Reconciliation statement

Non-Self-Accounting Units

These are Ministries and extra-ministerial departments which maintain complete records of Below-the- line payments and receipts (Salary Advance Accounts) but incomplete record of Above-the –line (Budgetary Account) payments and receipts. All transactions of this type of unit are conducted through Federal Sub-treasury or Federal Pay Office in the state to which vouchers are presented for checking and payment. Revenues received are paid into the account of the Federal Sub-treasurer or Federal Pay Officer who renders his returns, including those of the non-accounting unit, to the Accountant-General of the Federation. Non-self accounting units do not render transcripts. Examples of Non-self Accounting Units include Federal Ministries in any state.

Sub-Accounting Units

These are Ministries and Extra- ministerial Depts. where the accounting officers render non-detailed monthly accounts to the Accountant-General. Accounts are rendered in sub-head aggregate form, accompanied by the original vouchers.

Sub-Accounting units:

- Are approved by the Ministry of Finance as Sub-Accounting units;
- Write an Accounting Manual or Code which is approved by the Accountant-General and Auditor-General;
- establish an internal audit department;
- Operate a central pay office;
- Operate two current accounts with CBN – one for revenue and the other for capital expenditure.

Returns rendered to Accountant-General by Sub-Accounting units include:

- Monthly Transcripts (to be audited by the Auditor-General's staff before being sent to the treasury);
- Vouchers in support of the transcripts in original and duplicate ;
- Copies of Vouchers relating to its own Head in support of monthly transcripts; and
- Schedule of expenditure in sub-head aggregate form.

Examples of Sub-Accounting units are Federal pay offices, customs Area offices and police pay offices.

Divisions in Auditor-General's Office for the Audit of Various Types of MDAs

1. **Revenue Audit Division**: For the audit of revenue earning MDAs e.g. Customs and Excise, FIRS, Federal Ministry of Petroleum Resources etc
2. **Self-Accounting Ministries/Departments Division**: For the audit of self-accounting Ministries/departments e.g. Ministry of Education, Works, Finance etc
3. **Defence and Security Division:** For the audit of the accounts of Ministry of Defence, the Armed Forces, the Police and other security agencies

Internal Audit Departments

Financial Regulations 2201 requires that the Accounting Officer of Ministries and Extra-Ministerial Depts. (Self-Accounting and Sub-Accounting) establish internal audit departments (subject to availability of staff), to provide a complete and continuous audit of the accounts and records of revenue, expenditure, plant, allocated and unallocated stores.

The Chief internal auditor is responsible to the Accounting officer and submits to him and the Auditor-General for the federation the following documents:

- Detailed audit programme
- Monthly internal audit report; and
- Half-yearly internal audit report (also sent to the Accountant-General).

Duties and responsibilities of Govt. Internal Audit Units

As stipulated by the existing Financial regulations, the responsibilities of Internal audit units include to:

- Carry out continuous examination of all accounting books and records maintained by the Ministry or department;
- Determine the adequacy of the internal control system;
- Ensure that an adequate system of securities exist in the Ministry/Department;

- Check all payment vouchers originating from any section of the Ministry/Department before payments are made;
- Check the reliability of the accounting and reporting systems;
- Carry out any special review or assignment which may be required by management; and
- Co-operate with and assist the Office of the Auditor- General for the Federation in making available necessary documents for the final audit of the establishment.

Note:

- The Office of the Accountant-General of the Federation has either a Federal Sub-Treasury or a Federal Pay Office in each state.
- The Office of the Auditor-general has a branch in each state of the Federation.
- The Federal Auditors (officers of the Auditor-General) audit the Federal Establishments at the various states (e.g. the Federal Pay Office).

3.3 Audit of Federal Government Parastatals

Federal Parastatals are governmental units set up to perform a single function or a restricted group of related activities, some of which are social. Some may be set up to perform some functions the MDA's are not adequately equipped to accomplish e.g. hospitals, schools, transportation system, airports, seaports, electricity and gas (PHCN, NNPC, LNG etc) public housing etc

They are variously referred to as Corporations e.g NRC, NPA; Boards e.g Waste Management Board, Commissions e.g. INEC, National Population Commission (NPC). Each Parastatal has its enabling Act that defines its statutory duties and functions. Some are registered limited liability companies wholly or partly own by Government.

Objectives of Auditing Federal Parastatals

To ascertain if:

- ✓ Proper accounting records are being kept;
- ✓ All revenue items are collected and properly accounted for;
- ✓ Adequate controls exist to ensure the safety and proper use of the organizations funds and assets.
- ✓ The organization's Chief Executive and other top management carry out on those functions and operations for which the organization is established

- ✓ Proper accounts are being prepared in accordance with the financial and accounting clauses as provided in the enabling Act; and

- ✓ The audited financial statements reflect a true and fair picture of the activities of the Board or Corporation.

Auditor-General and Audit of Parastatals

By the Sect.85(3), 1999 Constitution, the Auditor-General shall not audit the accounts of or appoint auditors for Government parastatals (corporations, commissions, authorities, agencies, including all bodies established by any Act of the national Assembly).

The Auditor-General is authorised to:

a. provide such bodies with –

- A list of auditors qualified to be appointed by them as external auditors;

- Guidelines on the level of fees to be paid to external auditors;

b. Comment on their annual accounts and the auditors' report thereon**.**

By the Sect.85(4), 1999 Constitution gives the Auditor-General power to conduct periodic checks of the Government Parastatals. The audited accounts of parastatals, signed by their Boards, along with the domestic reports on them, are forwarded to the Auditor-General for the Federation for vetting. The A-G certifies the accounts after vetting, issues the "Auditor-General's certificate" and the "Auditor-General's Report" and submits the accounts and reports thereon to the National Assembly.

Note: Where the Parastatal is a limited liability company, the account is prepared and audited in line with the provisions of CAMA, cap C 20, LFN 2004

Parastatals that receive subventions and grants from the government reflect fund accounting system in their accounts. Generally, as self-accounting units, the main accounts prepared by them consist of:

- Receipts and Payment Accounts – equivalent of Cash book;

- Income and Expenditure account

- The balance sheet (Statement of Financial position) referred to as a statement of Assets and Liabilities.

- Explanatory notes and schedules.

Public Sector Audit Procedures

Audit procedures for verification of assets and stores are as in private sector audit. However peculiarities exist in Public sector accounting system, thus peculiar audit procedures are adopted in respect of verifying:

- Revenue
- The Departmental Vote Allocation Book (Vote Book)
- Contract
- Cash Book; and
- Control of security documents

Audit Procedures for verifying Revenue

- Conduct a cash survey on the revenue collector – an officer in charge of collecting revenue from the public and in possession of TR.6 (Treasury receipt book 6); he keeps a cash book.
- Ascertain all receipts issued to the revenue collector after the last audit.
- Trace all the triplicate copies of receipts into the revenue cash book maintained by the revenue collector.
- Cast the cash book to ensure accuracy.
- Verify the total collection as recorded in the revenue cash book with the TR.6 pasted on the cash book for evidence of payment to the main cashier
- Examine the bank tellers and confirm at the CPO (central pay office) that all cheques received have been correctly and completely entered.
- For tenement rates, obtain copies of the latest assessment notice and list of outstanding from the previous year.
- Evaluate the system of internal control for the handling of all receipts of revenue
- Ensure that in general:

✓ The classification of revenue is in accordance with year's Estimates;

✓ Receipts are issued for all money collected and such receipts bear the stamp of office of issue;

✓ All entries in the cash book include the dates and numbers of receipts;

✓ Revenue collectors do not make any payment out of the money collected by them;

- ✓ Revenue collectors submit their cash books and receipt books for examination to the Sub-treasurer;
- ✓ The Accounting officer prepares regular returns of revenue arrears;
- ✓ Where paper money e.g. bank notes, cheques, money order etc, is received by post, such should be entered in a paper money register under the supervision of the officer in charge of opening incoming mails in the ministry. Thereafter, the register together with the remittance should be passed to the cashier who will issue the receipts or licences in respect of the amounts and record them in his cash book;
- ✓ Conduct spot checks of revenues collected.

Audit Procedures for Vote Book

- Obtain the approved estimates for various Heads and Sub-Heads;
- Obtain copies of the Financial warrants/Authority to incur expenditure (AIE) issued to the Ministry/Department;
- Post the warrants to the vote book to ensure there is authority for the entries made;
- Ascertain the officers who are authorised to control and spend the votes;
- Ensure that all vouchers, including the liabilities, are posted to the Vote Book;
- Ensure that correct adjustments are made in the "balance available" column

  whenever the actual cost is greater or less than the liability figure already noted.
- Ensure that no unauthorised liability or expenditure is incurred and that over-expenditure is avoided;
- Ensure that each entry is initialled by the authorising officer;
- check all the various instruments of virements; and
- Ensured that where there is a mistake, the entry is reversed in red or black ink as applicable;

Audit Procedures for Contract/Project Accounts

- Check contract agreements with the minutes of tenders Board meetings;
- Open the contract register and update it for control purposes;
- Ensure that interim payments are in line with the contract agreements;

- Examine the completion certificates to ensure that payments are made on the appropriate certificates given;

- Conduct physical inspection of work done to ensure compliance with terms of contract and completion of work certificates given;

- Ensure that the correct retention amounts are deducted; and

- Ensure that all necessary deductions, including taxes, recovery of advance payments, retentions etc are made before payments and that those payments are properly authorised.

Audit Procedures for Cash Book

- Conduct a cash survey to verify if the cash book balance agrees with the physical cash produced for survey;

- Trace the receipt vouchers(TR.6) to the cash book and ensure that all of them have been correctly posted;

- Verify revenue collected and paid to the bank by reference to the bank tellers;

- Ensure that the cash book entries contain individual Treasury receipt numbers;

- Trace the payment vouchers to the cash book serially and confirm that all postings are complete and accurate;

- Ensure that all cheque numbers (where applicable) are correctly indicated in the cash book;

- Ensure that the amount on each cheque is equal to the corresponding voucher and that the cheque number is written on the corresponding voucher; and

- Cast the cash book, ensuring that every brought-forward and carry-forward balances from one page of the cash book to another are correctly transferred.

Control of security Documents: Audit Procedures for the Document Register.

- Check if orders for new supplies of cheques or printing of receipts are authorised by the designated officer in the Finance department;

- Ensure that all deliveries of new supplies are recorded in the appropriate register, for example, cheque stock register or security book register;

- Check that all issues of stock are recorded in the appropriate security book register and signed by authorised recipients;

- Request to see all cancelled cheques for audit inspection;

- Ensure that all the security documents whether currently in use or not are kept in a safe under lock and key;
- Ensure that there is a prior written approval/consent of the Accountant- General of the federation for the transfer of receipt books between any two sub-accounting officers.

3.4 Types of Public Sector Audits

There are three main types, namely:

- Regulatory or Compliance
- Financial; and
- Money-for-value Audit

Regulatory (Compliance) Audit

This is aimed at ensuring that expenditures have been incurred on approved services and in accordance with the enabling statutory provisions and regulations governing the particular expenditure.

Documents an auditor requires for this type of audit include -

- ✓ The Nigerian Constitution (as amended)
- ✓ Civil Service rules
- ✓ Treasury circulars
- ✓ Establishment circulars
- ✓ Official Gazettes of government
- ✓ Financial regulations
- ✓ Budgets etc

Audit of projects or contracts fall within this category**.**

Financial Audits

These are conducted to ensure that the accounting and financial control systems are effective and efficient in operation as well as to ensure that financial transactions are properly authorized and accounted for.

Financial audits seek to confirm that the financial statements have been prepared to faithfully represent the state of affairs of the establishment within the period covered by the audit.

Audit of Treasury accounts fall within this category.

Value for Money Audit

Value-for- money audit, also referred to as Performance, seeks the maximization of the use of resources for the welfare of the public by ensuring that activities and programmes are carried out at low cost and to high standard. In addition to ensuring that financial statements faithfully represent the affairs of the establishment in relevant cases, the audit objective includes an ascertainment of whether the establishment being audited is achieving the purposes for which its programmes are authorized and whether it is doing so efficiently, effectively and economically.

Elements of Value-for-money Audit

The elements of Value-for-money audit are economy, efficiency and effectiveness (the 3Es).

Economy: This involves minimization of input costs for an activity while having regard for quality. An economical operation acquires resources in appropriate quality and quantity at the lowest cost.

Efficiency: This involves an attainment of a high input-output ratio. Thus, efficiency is concerned with the achievement of maximum useful output from resources deployed to an activity. It ensures that only minimum level of resources is devoted to achieving a given level of quality output.

Effectiveness: This is concerned with the extent to which objectives have been achieved. Thus, effectiveness connotes the achievement of desired results by the output.

Techniques of Value-for money audit.

- **i**. Analysis of KPIs and trends and the investigation of deviations/exceptions. This is aimed at identifying areas that need specific attention.
- **ii**. Management and systems review: For the purpose of investigating the processes of establishing objectives, implementing policies and monitoring results. This is with a view to evaluating efficiency.
- **iii**. Analysis of planning and control processes: With a view to evaluating the effectiveness of the oversight function.
- **iv**. Effectiveness review for the purpose of ascertaining whether activities and programmes are achieving the objectives for which they have been undertaken.
- **v**. Efficiency assessment involving specific investigation into some activities with high unit cost, poor performance measures etc with a view to identifying appropriate remedial action for the poor performance.
- **vi**. Reporting on the VFM audit – Discuss draft with appropriate officers/committees before finalizing.

Self-assessment questions

1. Outline the audit procedures for the audit of revenue and the cash book.
2. Explain the elements of VFM audits and state the techniques of VFM audit.

Audit of Teaching Hospitals

Teaching hospitals render services to patients and the society, many of which are not-for-profit. They equally receive income from various sources, some of which are outside the ordinary business of the hospitals. Some of these revenues may be capital in nature, including subventions from government, donations from donor agencies and philanthropists, research institutes, international agencies and charities. Identifying and properly accounting for these revenues and appropriately matching the related costs against the revenues in the appropriate periods becomes a challenge to the auditor.

Legal and Regulatory framework

It is important to have a full understanding of the legal documents establishing and regulating the activities of the teaching hospital. These may comprise the Act or Edict establishing the hospital as well as guidelines issued by regulatory agencies such as the Medical and Dental council.

Revenue Sources

Revenue from the ordinary activities of a teaching hospital may fall under the following categories:

- Consultation
- Drugs
- Surgery
- Nursing care
- Bed fees
- Delivery charges
- Card fees
- Feeding
- Mortuary fees
- Dialysis
- Laboratory tests
- Blood infusion etc

Problems Associated with the audit of a Teaching Hospital

The difficulties associated with the audit of a teaching hospital include:

1. **Stock Valuation:** Stocks usually consist of drugs, consumable supplies and disposable items, some of which have expiry dates. The auditor may lack the skills to determine the

condition of the items, in addition to the difficulty of tracking and examining the items individually in order to determine the expiry dates. The auditor therefore needs to inquire and review the costing method with regard to materials in store and where necessary seek the help of a specialist for the valuation of specialized items.

2. **Cut-off Problems:** A patient's admission may extend beyond one accounting period. In addition to the difficulty of analyzing the charges to a patient into the appropriate revenue heads, there is also the problem of appropriately matching costs with related revenue. Where advance payments (deposits) are received from patients, the auditor faces the difficulty of ensuring that such deposits are properly apportioned and accounted for in the periods to which they relate. The auditor will need to review the basis of apportionment and do a re-computation of the accrued revenue to ensure its reasonableness and accuracy.
3. **Debtors and Bad debts Provision:** Incidence of bad debts is usually high in hospital business especially in cases where the patient dies while undergoing treatment. The auditor needs to review the debtors figure with a view to ensure that adequate provision has been made for debts doubtful of collection.
4. **Internal Control problems:** The peculiar nature of hospital business gives rise to unavoidable weaknesses in the internal control system. Patients may be admitted at irregular and odd hours of the night, e.g. accident and armed robbery victims, and response to such emergencies may deviate from the normal and routine. The auditor, therefore, needs to:
    - assess the procedure for dealing with such emergencies as they may provide avenues for loss of funds and materials.
    - review controls over revenue/cash collection during night shifts and public holidays;
    - review controls over issue of drugs and materials during emergencies; and
    - billing system for services rendered during such irregular periods.
5. **Valuation of non-current assets (particularly specialized equipments):** There are usually sophisticated and specialized equipments whose value may depend on the condition of the asset. Specialized skills are needed in such cases to determine the effect of obsolescence on the assets. Some equipment could also be provided by donors, some of whom may be foreign-based. Thus, it may be difficult to establish the full monetary value of such equipment for accounting purposes.
6. **Valuation of Liabilities:** Theliabilities of a teaching hospital may include contingent liabilities for pending litigation resulting from one form of negligence or the other. Identifying and estimating the value of such claims introduce difficulty in the audit. The auditor may need to make enquiries of management/officials and examine available correspondence to establish the existence and possible value of such claims.
7. **Reporting:** reports may be required in specified formats for presentation to supervising authorities and/or donor agencies. In addition to ensuring and reporting on the truth and fairness of the financial statements, the auditor will need to comply with the required reporting format.

4.0 Conclusion

The Constitution of the Federal Republic of Nigeria provides the institutional arrangement for the establishment of the Office of Auditors-General at the Federal, State and local government levels for the purpose of auditing the treasury accounts, the MDAs and parastatals of government. The Auditors General send their reports to the PACs at the respective levels of government for deliberation, recommendations and action. The Offices of the Auditors- general perform three different types of audits, namely, Regulatory or Compliance, Financial and Money-for-value Audit. It is common these days for environmental audits to be conducted, which is more like a compliance audit.

5.0 Summary

This unit examined the legal and regulatory framework for public sector audits, the constitutional arrangements for the establishment of the Offices of Auditors-General at the Federal, state and local government levels. We further discussed in detail the audits of Treasury accounts, MDAs and Parastatals.

6.0 Tutor-marked assignment

1. Discuss the difficulties associated with the audit of a teaching hospital.

2. You are anaudit manager in the firm of Popoola & co (Chartered Accountants). You have been given the responsibility of briefing the audit juniors on the peculiarities of public sector audits.

Required:
Prepare you presentation addressing the following:

i. the meaning of Self-Accounting Units (2 marks)
ii. the meaning of Sub-Accounting Units (2 marks)
iii. the objectives of auditing Ministries, Departments and Parastatals (MDAs). (6 marks)
iv. audit procedures for validating Contract/Project Accounts. (5 marks)

(Total 15 marks)

7.0 References/further reading

1. The constitution of the Federal Republic of Nigeria
2. Finance (Control and Management Act, Ca. F.26 LFN 2004
3. The Financial regulations (revised)
4. The Public procurement (Due process) Act 2007
5. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

UNIT 19: OTHER SPECIAL AUDITS

Content

1.0 Introduction

This unit looks at the structure, associated problems and audit approaches of hotels, pension contributions, charities and Primary Mortgage institutions.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the appropriate audit approach for the audit of hotels
- Discuss the auditor's duties with regard to pension audits
- Evaluate the problems associated with the audit of charities and design appropriate audit procedures to address these problems

Explain the issues that should capture the auditor's attention in the audit of Primary Mortgage Institutions (PMIs) and describe audit procedures to address these areas of audit emphasis.

3.0 Main Content

3.1 Audit of Hotels

Revenue sources for a hotel are diverse and are not of standard value. Different classes of accommodation attract different rates and different meals also attract different prices often determined by the attendants and waiters. Again, hotels have 'unlimited' hours of business: guests arrive at any hour including odd hours of the night. In some cases, guests make deposits and may not utilize the services paid for or may utilize them in part, occasioning refunds, the computation of which may be open to abuse. These peculiarities of the hotel business create control problems which the auditor needs to consider in designing his procedures.

Sources of Revenue

Revenue sources for hotels include:

- accommodation (proceeds from room occupancy);
- proceeds of meals served in restaurants and room service;
- bar sales – snacks, beverages and tobacco etc;
- laundry services;
- hire of conference halls;
- car hire service;
- telephone and internet services etc.

Audit approach/procedures

1. Auditor should review and assess the check-in procedure so as to ensure adequate control over initial deposits paid by guests, billings for the rooms and refunds for unutilized deposits. The auditor should:
   - Check the daily cash summaries and agree with the daily chart to ensure that guests have been appropriately billed;
   - Agree the daily collections with relevant bank paying in slips to ascertain that all takings have been fully banked;
   - Agree refunds made to the relevant bills and deposits and trace the payments to the imprest cash book;
   - in case of credit customers, identify the individual charges to the monthly bills.
2. For restaurant services, the auditor should:
   - Ascertain the costing method for meals served and trace the bills on sample basis to the cash receipt books;
   - Agree individual bills to the menu and confirm additional charges e.g. service charge and VAT.
   - Ensure that service charges include room service (where applicable) billed at the appropriate rate.
3. Audit tests should be conducted for purchases and daily sales with respect to the bar and restaurant accounts. A physical stock check should be undertaken. The auditor should ensure that:
   - All food requisitions are backed by valid order
   - All orders are properly invoiced
   - All invoices are properly booked
   - All cash takings are properly accounted for; and
   - Adequate controls exist over receipts and issues of stock of food and drinks.

4. Telephone, fax and internet bills should be checked to the respective logs and tracked there-from to the individual guest bills.

5. Review the procedure for hire of halls and accounting for the related income. Hire of conference halls should be confirmed by reference to related correspondences to ensure adequate billing and effective collection.

6. Debtors for unpaid bills should be verified like any other trade debtors. Auditor should pay particular attention to the procedure for granting credit, the status of the debtor and the paying pattern/history. Adequate attention should be paid to government debts. Ensure adequate provision is made for doubtful accounts.

7. The assets and liabilities of the hotel are verified in the normal way – as any other entity's assets and liabilities.

3.2 Pension Audit

A worker receives pensions on retirement or on the attainment of a specified age. The payment may be a lump-sum or paid as an annuity. Since pension payment is a recurring liability for employers, they build up funds for this purpose through contributory pension schemes.

Under the 2014 Pension Reform Act, the responsibility of managing the pension funds rests with the Pension Fund Administrator (PFA) that collects the remittances from employers and manages them on behalf of the employee until maturity. By the provisions of the Act, an eligible employer makes a mandatory minimum contribution of 10% of employee's monthly emolument (calculated as the sum of basic salary, cost of living allowance, transport and housing allowances) while the employee contributes 8% of his/her monthly emolument. An employer may elect to bear full responsibility for his employees' retirement benefit/pension contributions. In this case, the employer is required to make a contribution of not less than 20% of the employees' monthly emoluments to the fund. An employee, in addition to the 8% minimum contribution can make voluntary contributions to his savings account.

Auditor's Duties

1. Examine the employment contract/agreement between the employees and the employer and ensure that all eligible employees are registered under the pension scheme based on the provisions of the employment agreement..
2. Verify that the pension deductions agree with the provisions of the Pension Reform Act, 2014.
3. Verify that proper control is exercised over the transactions of the fund with regard to deductions from contributors' wages and the total contributions remitted to the PFA. Ensure that contributions are remitted on timely basis.
4. Where an employee makes voluntary contributions to his pension savings account through payroll deduction, ensure that such additional contribution is promptly remitted to the PFA.

5. Ensure that employees' realizable assets under the old pension scheme are either paid to the employees or transferred to the new PFA.
6. Where an employee has changed to an employer whose pension funds are managed by a different PFA, ensure that the employee's contributions are remitted to the right PFA.
7. Ensure gratuities paid to retiring employees agree with actuarial valuations by an actuary of liability due
8. Review actuarial report and ensure right method has been used by actuary [Projected Unit Credited Method (PUCM).]
9. Check the completeness and reasonableness of the assumptions used by the actuary
10. Consider using experts to review actuarial report if you don't possess the skill.
11. Determine and state in the management letter whether the pension fund is being managed in the interest of the employees.

Self-assessment questions

1. Discuss the control problems associated with the audit of hotels.

2. Describe the audit procedures for the audit of pension contributions.

3.3 Audit of Charities

Charities are not-for-profit organizations set up by philanthropic organizations or individuals to engage in welfare activities.

Note: Not-for-profit organizations are peculiar in their structure, funding and activities, in that:

- They receive significant amounts of resources from providers who do not expect commensurate or proportionate pecuniary returns;
- They do not operate to provide goods or services at a profit; and
- There are no ownership interests like those of business enterprises.

There are no strict legal rules governing charities except that they should not engage in illegal or anti-social activities. Some charities may be incorporated as companies limited by guarantee.

Problems associated with the audit of Charities

i. Staff of charity organizations may not be knowledgeable in accounting and finance, resulting in poor systems of internal and accounting controls.
ii. Charities have diverse sources of revenue and this creates the problem of determining the completeness of receipts/income.
iii. Expenses are difficult to track as most are not covered by receipts e.g. resettlement cash paid to refugees.
iv. Benefit-in-kind received from donors may not be appropriately measured and valued for accounting purposes.

v. The activities of charities may be diverse and unrelated that there may not be consistent method of recognizing income or accruing for expenses.

Audit Approach

i. Obtain and study the constitution of the charity in order to gain an understanding of its objects, as well as the accounting and audit requirements.
ii. Document properly the objects of the engagement and the nature of the report in the letter of engagement.
iii. Verify all funds inflow in order to ensure completeness. Repayable funds should be isolated from revenue and properly classified as liability.
iv. For legacies through Wills, obtain and study copies of the wills to ensure all legacies are received in full as devised by the testator.
v. Verify donations. Ensure cheques are restrictively crossed and that such donations are acknowledged.
vi. Cash collections, including collections in boxes and tins, should be counted in the presence of two persons, recorded and acknowledged by the volunteer responsible for the custody.
vii. Verify expenditure by reference to duly authorized vouchers. Outstanding expenditure by year end should be verified and the liability recognized in the books.
viii. Verify the existence, ownership and valuation of all fixed assets. Allocate appropriate values to all gifts in kind.
ix. Assess the liquidity and going concern status of the Charity with a view to expressing appropriate opinion should there be acute liquidity and going concern problem.
x. Where donations are received in kind, the auditor should state the appropriate monetary measurement and properly classify them as to revenue and capital.
xi. The nature of the report issued by the auditor will depend on whether the Charity is a company limited by guarantee, an incorporated trustee or an unincorporated entity. Depending on the nature of the Charity, the underlying audit objective may not necessarily be the expression of opinion on the 'true and fair view' of the financial statements but rather on obtaining an assurance as to the honesty, integrity and competence of the handlers of the affairs of the Charity.

Note: Where the Charity has an overseas affiliate, the auditor should ensure that its financial statements meet the requirements of the overseas sponsors.

3.4 Audit of Primary Mortgage Institutions

Primary Mortgage Institutions (PMIs) are classified as other financial institutions and are thus covered by sections 56 – 59 of BOFIA. They are supervised and regulated by CBN. PMIs are engaged in originating, marketing and servicing mortgage loans either as principals or agents. They engage in four main activities namely:

1. Mobilization of savings;
2. Lending of funds for the acquisition of real estate;
3. Purchase and sale of mortgage loans; and

4. servicing of mortgage loans

In the audit of PMIs, attention is paid to **three** main areas:

a. Income recognition;
b. Loss recognition; and
c. Classification and disclosure in financial statements.

Income Recognition

- ❖ Each significant item of revenue should be reported separately to enable the user assess the contribution of that particular source to the overall income of the organization.
- ❖ The significant items of revenue include income from loans, lease rentals, factoring, credit-related fee income, non-credit related fee income etc.
- ❖ Where the success of any transaction is doubtful and the income from such transaction is contingent upon completion of the transaction, such income should not be recognized until it is reasonably certain that the transaction will be completed.

Loss Recognition

- ❖ Loan portfolios should be classified as performing and non-performing facilities.
- ❖ After a systematic review of all credit risks, including loans, leases and off-balance sheet engagements, the PMI should estimate and make general and specific provisions against loan losses, taking into account the long-term nature of the loans and the available loan security (collateral). Provisions should be made as follows:
  - Repayment overdue for 3 months: No further income is recognized until regular payments resume;
  - Repayment overdue for more than 6 months: consider provision against principal;
  - Repayment overdue for over one year: un-provided portion of outstanding loan should not exceed 50% of estimated net realization value of security.
  - Principal repayment overdue by more than 2 years: make 100% provision for loan loss.
- ❖ Other losses arising from other transaction e.g. foreign exchange transactions, sale of securities or loans etc. should be appropriately recognized.

Classification and Disclosure

In addition to the disclosure requirements of IAS 5- *Information to be disclosed in financial statements,* PMIs should disclose:

i. The method and bases by which provisions for loan and/or securities losses are made;
ii. The nature of off-SFP engagements and the methods of recognizing income or loss thereon;
iii. Total liabilities to National Housing Fund (NHF);
iv. Total value of mortgage assets and movements thereon;
v. Sources of funds, aside share capital and NHF;
vi. Classification of mortgage loans receivable and mortgage backed securities into those held for sale and those held for long term investment.

Note: The auditor in addition to the statutory auditor's report, submits various types of reports to the regulatory agencies in line with the provisions of the regulatory statutes.

4.0 Conclusion

Certain entities by their structure and the nature of the industry they belong to, present peculiar audit problems, especially in the area of controls. Hotels, Pension contributions, charities and Primary Mortgage institutions belong to such entities. The audit objective is to design appropriate procedures as given in this unit to address these peculiar features and challenges.

5.0 Summary

This unit centred on the audit of the hospitality industry, pension fund, charities and Primary Mortgage institutions. The peculiarities of these institutions and the associated audit challenges are discussed. For each of these institutions, appropriate audit procedures to address these peculiarities and challenges are suggested.

6.0 Tutor-marked assignment

1. You are the senior manager in charge of the audit of Wisdom Lt). The engagement partner has given you the responsibility of briefing the audit juniors on the peculiarities of the audit of Primary Mortgage Institutions pension Charities.

Required:

Prepare your briefing notes in which you highlight the following:

a. The risk areas of a PMI audit and audit procedures needed to validate these areas
b. The peculiar problems associated with the audit of charities and the audit procedures to address them.

7.0 References/further reading

1. Banks and Other Financial Institutions Act (BOFIA) 1991 as amended

2. Pension Reform Act 2014.

3. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

UNIT 20: FORENSIC AUDITS AND INVESTIGATIONS/DUE DILIGENCE

Content

1.0 Introduction

This unit's focus is on forensic audit and investigations, its nature and process as well as situations requiring forensic investigation. The unit extends its discussion to due diligence exercises and examples of due diligence exercises that could be conducted.

2.0 Objectives

By the end of this unit, you should be able to:

- Explain the concepts forensic accounting, forensic audit and forensic investigation
- Discuss the process involved in forensic investigation
- State the qualities of a forensic auditor and identify situations where the services of a forensic auditor may be needed.
- Explain the term, 'due diligence'.
- Describe the areas of an entity's activities that could require the conduct of a due diligence
- Prepare a due diligence report.

3.0 Main Content

3.1 Definition of Concepts

Forensic accounting: The application of accounting, auditing, and investigative skills to conduct an examination into a company's financial statements. The objective of forensic accounting is to provide an accounting analysis that is potentially suitable for use in court. Forensic accounting covers both forensic investigations and forensic audits. It includes the audit of financial information to prove or disprove a fraud, the interview process used during an investigation, and

the act of serving as an expert witness. Thus it encompasses both litigation support and investigative accounting.
Note: Forensic accounting can be used in situations other than fraud, e.g. settling monetary disputes in relation to a business closure, marriage break up, insurance claim, etc.

Forensic investigation: This is a process of carrying out procedures by a forensic accountant, to gather evidence which could ultimately be used in legal proceedings or to settle disputes. Alan Zysman defines forensic investigation as the utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law. This could include, for example, an investigation into money laundering. A forensic investigation involves many stages (similar to an audit), including planning, evidence gathering, quality control reviews and reporting.

Forensic auditing: is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. It refers to the procedures carried out in order to obtain reliable and acceptable evidence for anticipated disputes or litigation. Thus, to Alan Zysman, forensic audit is an examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court. This could include, for example, the use of analytical procedures, and substantive procedures to determine the amount of a payroll fraud or an insurance claim, or the amount of rent owing under a lease agreement that is the subject of litigation etc.

Theservices of a forensic auditor may be required in different situations. These include but not limited to:

(i) Theft and frauds

(ii) Bribery allegations

(iii) Tax evasion

(iv) Insider dealings

(v) Wrongful dismissals

(vi) Business interruptions

(vii) Property losses
(viii) Insurance claims

(ix) Personal liability claims

(x) Construction claims
(xi) Bankruptcies
(xii) Breach of contract

(xiii) Stock market manipulations
(xiv) Arson
(xv) Matrimonial divorce claims
(xvi) Investment scam
(xvii) Management/employee wrong doing
(xviii) Royalty audits and
(xix) Expert witness testimony

Qualities of a forensic Auditor

The qualities of a forensic auditor include (i) Ability to identify fraud with minimal information (ii) Identification of financial issues significant to the matter (iii) Knowledge of investigative techniques (iv) Knowledge of the rules of evidence in court (v) Ability to interpret financial information (vi) Ability to communicate findings in a language that is understandable by a layman (vii) Possession of investigative skills(viii) Possession of investigative mentality (ix) Computer literacy

Differences between Forensic Audit and Financial Audit

The procedures and skills needed in carrying out forensic audit and financial statement audit are the same but the following differences could be noted between the two types of audits.

i. The objective in financial audit is to give an audit opinion on the financial statements while forensic audit aims at detecting material frauds and misstatements
ii. Financial audit depends on examination of audit trail while forensic audit depends on examination of events and activities behind the documents.
iii. Financial audit is conducted strictly according to standards, guidelines and applicable legislations and framework whereas no such restriction is placed on the scope of forensic audit
iv. Financial audit is usually statutory whereas forensic audit is on ad hoc basis
v. The financial auditor reports to members of the client entity while forensic auditor reports to the persons who appointed him.

Objectives of Forensic Investigation

1. To determine if a deliberate fraud with the intention of stealing the assets of entity or individual has actually taken place. There is a possibility that the matter under investigation could have arisen through mistake or through deliberate criminal action.

2. To discover the perpetrator(s) of the fraud, and ultimately to assist in their prosecution. The investigation will gather evidence, which may include an interview with the suspected fraudster, which can then be used in criminal procedures against the individual(s) concerned. Where a primary suspect exists, it is important to extend the

investigation to discover if there are other people involved, as frauds often involve collusion between several individuals.

3. To quantify the financial loss suffered by an individual or entity as a result of the fraud. The evidence gathered will determine the amount which involved in the fraud. It is important for the loss to be quantified, as legally a crime is said to have been committed if a victim has suffered a financial loss.

Steps in Forensic investigation

The specialist skills of a forensic investigation team will produce evidence which is sufficient and relevant enough to be used to assist legal proceedings against those involved with a fraud or any matter that is a subject of litigation. The steps involved in such investigation include:

1. Determination of the type of fraud that has taken place and to consider how it has taken place. The investigator will also need to establish how long the fraud has been operating.
2. Gathering of evidence – this is a crucial part of the investigation as it should determine both the identity of the perpetrator(s) and the monetary value of the fraud. Gathering evidence could include an examination of accounting records and other documentation, interviewing employees of an entity or other parties involved in the matter and discussions with the concerned party/litigant. A key issue here is to ensure that the evidence will be sufficient to prove three matters:
    - That a fraud has taken place;
    - The identity of the fraudster, and
    - The amount of the loss to the company.

    This is essential because the legal framework will require clear evidence in order for a prosecution to be instigated against the perpetrator(s) of the fraud. Evidence must be sufficient and relevant to the accusations being made. For example, the legal framework is likely to require evidence of the following:
    - The motive for the fraud,
    - The ability of the alleged fraudster to conduct the fraud, and
    - Any attempt made by the alleged to conceal the crime.

    The investigation should also involve an interview with the suspect(s), with the aim of extracting a confession. This would form a key part of the evidence to be ultimately presented at court.
3. Examination, Analysis, verification and evaluation of data/evidence obtained. This is very important in view of the fact that the report presented must be very factual and neutral as the investigator may be required by the legal framework to explain and substantiate the evidence he obtained.

4. Reporting: The investigator will produce a report, summarising all findings and concluding on the identity of the fraudster(s) and the amount of financial loss suffered. Care must be taken in crafting the report as it will likely be presented as part of evidence

during court proceedings and the investigator would be likely called as an expert witness during the legal process.

Finally, advice may be provided by the investigator as to how to prevent the kind of fraud investigated from occurring again.

Alan Zysman however has suggested the following steps as atypical approach to forensic investigation:

1. Meet with the client;
2. Perform a conflict check;
3. Perform and initial investigation;
4. Develop an action plan;
5. Obtain relevant evidence;
6. Perform analysis;
7. Prepare a report

3.2 Due Diligence Procedure for Mergers and Acquisitions

Due diligence is work commissioned by a client, involving agreed inquiries into aspects of an organization, its accounts or activities of another organization the client is interested in making substantial investment in or even a complete takeover. Thus due diligence is usually associated with takeovers and mergers and other buy –in arrangements. A typical due diligence engagement involves performing an assessment of the material risks associated with a merger or takeover transaction (including validating the assumptions underlying the acquisition) to ensure that the acquirer has all the necessary facts and that the business opportunities are real.

Due diligence may include the following aspects:

- *Financial due diligence*: A review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations. This will involve a confirmation of title to all assets as well as their existence. A review of liabilities including contingent liabilities and all banking/funding covenants.
- *Operational and IT due diligence*: A review of operational and IT risks, including quality of systems, associated with a target's business.
- *People due diligence*: A review of the key staff positions under the new structure, contract termination costs and costs of integration.
- *Legal/regulatory due diligence*: A review of the target's level of compliance with relevant laws/regulation.
- *Environmental due diligence*: A review of the environmental, health and safety and social issues in a target company, including compliance and procurement of all necessary approvals and licenses from relevant authorities.

A typical due diligence assignment will usually involve inquiries into:

- ❖ Structure of the target, including the ownership structure and changes that may be necessary on takeover.
- ❖ Credibility of the owners, the directors and senior management, including validation of the career history of the main players in the business.
- ❖ Financial health based on a detailed analysis of past financial statements and the existing asset base.
- ❖ Future potential of the target, reflected in the strengths of its products or services, its customer base and the probability of earnings growth over the medium and long term.
- ❖ Assessment of risk to the acquirer, in terms of their markets, strategy and likely future events.
- ❖ How realistic the business plan is (if any), including the reasonableness of the assumptions used and how well the business plan conveys the potential of the target.

Reports

Where it is required that an opinion, view or assurance be expressed, the assignment becomes a direct reporting assignment (where the accountant is required to give a special report on some aspects of a client's affairs) and this requires objectivity. Each report is different and is structured to meet the terms of engagement/scope of the assignment. All the items included in the engagement letter must be dealt with. It is important to include restrictions on the purpose for which the report can be used and the persons to whom it can be circulated.

Due diligence reports are varied based on the nature of the engagement, but generally takes the following structure:

- Title – Accountant's report to ……… on ……….
- Addressee
- A description of the subject matter of the engagement and time period
- Responsibilities of all parties
- Restricted nature of the report – who may have access to the report
- A liability disclaimer clause may be included to confirm that the engagement should not be relied upon to disclose errors or other irregularities.
- Standards (if any) used in the engagement, including documents used/examined
- Criteria against which the subject matter was evaluated
- The conclusion and any reservations to the conclusion, including the form of assurance appropriate to the assignment e.g. limited/negative assurance, reasonable assurance or positive assurance.
- Name, description and address of the accountant
- Date.

4.0 Conclusion

The procedures for carrying out a financial audit and investigation and forensic audit and investigation are basically the same but differ in certain aspects given in this unit. Due diligence engagement involves performing an assessment of the material risks associated with a merger or takeover transaction or any buy-in proposal to ensure that the acquirer has all the necessary facts and that the business opportunities are real. Aspects of an organization where due diligence could be conducted include finance, operations, legal/regulatory, human resources and environment.

5.0 Summary

In this unit we defined the concepts of forensic accounting, forensic audit and forensic investigation in an attempt to establish the relationship between them. We also identified the qualities of a forensic auditor and the situations requiring his services and concluded by identifying and describing the steps involved in forensic investigation. We also discussed due diligence engagements as a confirmatory exercise that the representations of a prospect are real.

6.0 Tutor-marked assignment

1a. Explain the following terms:
(i) Forensic Accounting;
(ii) Forensic Investigation;
(iii) Forensic Auditing.

b(i) Describe the objectives of a forensic investigation; and
(ii) Explain the steps involved in a forensic investigation into a payroll fraud, including examples of procedures that could be used to gather evidence.

2. Explain the term 'due diligence' and discuss any **four** practical examples of this type of assignment.

7.0 References/further reading

1. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

2. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.

UNIT 21: OTHER ASSIGNMENTS

Content

1.0 Introduction

Let us check out other assignments in this unit.

2.0 Objectives

After studying this unit, you should be able to:

1. explain transnational audit
2. explain social audit
3. explain environmental audit

3.0 Main Content

3.1 Transnational Audits

Transnational audits (TNAs) are audits of financial statements which may be used beyond an entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions. Transnational audits include audits of all financial statements of companies and other public interest entities which because of their size, products or servicesattract particular public attention. TNAs are particularly needful for entities that have significant transactions across national borders. The firms involved in TNAs are networks of independent firms with common processes and basic policies and standards but without common or central regulatory rules. Each independent firm is subject to national laws and professional regulations in the country in which it operates.

Features of Transnational Audits

TNAs are associated with some problems which can limit the reliability of the audited financial statements. These include:

- Regulation and oversight of auditors differ from country to country.
- There are differences in auditing standards from country to country, unless international standards are uniformly used.
- The possible variability in audit quality in different countries.

To mitigate these problems and in response to the trend towards globalization, the Forum of Firms (FoF) was founded by a network of global firms namely: BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton and PricewaterhouseCoopers. Membership is open to firms and networks that have transnational audit appointments or are interested in accepting such appointments. The FoF:

- Promotes the use of high quality audit practices worldwide, including the use of ISAs;
- Maintains quality control standards in accordance with International Standards on Quality issued by the International Auditing and Assurance Standards Board (IAASB), and conducts globally coordinated internal quality assurance reviews.

The IAASB has set up the Transnational Auditors Committee (TAC) to provide guidance to the members of the FoF. Membership of the Forum imposes commitments and responsibilities viz.:

- To perform transnational audits in accordance with ISAs
- To comply with Code of ethics for professional Accountants
- Be subject to a programme of quality assurance.

In relation to TNAs, these requirements/commitments go a long way in compensating for the weaknesses of local auditing standards which include:

- Standard setting being subject to political pressures
- Having inadequate resources by the standard setting body;
- Having sources of finance which raise questions about their independence ; and
- Being insufficiently timely in responding to market needs.

3.2 Social and Environmental Audits

3.2.1 Social and environmental Reporting

The activities of companies have social impacts, whether through the provision of products and services, the employment of workers and suppliers etc. These impacts may be positive or negative and companies cannot escape responsibility for them.Companies do not operate in isolation. They rely on the contributions of wider stakeholders beyond just shareholders and hence have a duty to take into account the interest and goals of these wider stakeholders in their decision making and operations. More importantly, companies cause social problems, e.g. pollutions, environmental degradation etc. and thus have responsibility to solve the problems they cause or prevent such social problems from arising.

Increasingly, many entities are now aware of social and environmental issues, and the effect that these entities have on social and environmental matters in their countries of operation. They have also become aware of the reputational risk and loss they may suffer should they fail to recognise social and environmental problems. Many entities thus are exhibiting a sense of public obligation to the social cost of their economic activities.In recent times, companies demonstrate their social and environmental policies, by publishing social and environmental reports. In Nigeria, reporting on social and environmental issues is not yet mandatory but is increasinglypart of the voluntary disclosures many public limited companies and other public interest entities make.

3.2.2 Social and Environmental Policies

Many entities have developed social and environmental policies as a demonstration of their commitment towards dealing with social and environmental matters.

Social policies cover such areas asemployee rights, employee training and development, human rights, child labour in developing countries, equal opportunities, health and safety matters, relationship with the local community and supporting local, national and international good causes.

Environmental policies cover such matters as, energy consumption, pollution, the use of natural resources and sustainability of the business and use of re-cycled materials.

Many public companies and public interest entities recently publish a social and environmental report, or a sustainability report as part of the voluntary disclosures in their annual reports and accounts. In such reports they demonstrate how they keep faith with their defined polices and level of achievement of their set targets on social and environmental matters.

Independent verification statement from a firm of accountants or similar firm of independent external experts adds credibility to such reports.

3.2.3 Social and Environmental Audits

Social Audit

A social audit is a process of measuring the socially responsible activities of an organization to determine their impact on the wider community. Social audits thus monitors, measures and appraises socially responsible performance. It is a way of checking whether a company has achieved set targets on social matters.

Social audits would strive at:

i. Establishing whether there is a rationale for a firm to engage in a socially responsible activity;
ii. Identifying that all current social and environmental programmes agree with the mission of the firm;
iii. Assessing objectives and priorities related to these programmes; and
iv. Evaluating company involvement in such programmes past, present and future.

The Canadian ethics audits have 6 components to social audits namely: Values-based standard setting, Document review, Benchmarking, Environmental scan, Multi-stakeholder surveys, action-enabling recommendation.

Values-based Standard setting – reviews whether the corporation has taken into account the values and interests of all stakeholders in its corporate policy – employees, host community, shareholders, retirees, industry institutions, human rights organizations etc

Document Review – Review of the administration manual, corporate code of ethics, board minutes and corporate policies, policies regarding business practices, conflict of interest etc to see the extent to which CSR principles are incorporated and practiced.

Benchmarking - Looks at the extent to which the company's behaviour and practices compare to industry norms and best practices.

Environmental Scan - Looks at the macro-changes in social climate, nationalism, technology, international trade policies etc that can transform the organization of the business or agency under study. The scan helps companies to adjust their policies and practices to align with best practice.

Multi-stakeholder surveys - Seek public opinion on the perception of significant stakeholders on the policies and actions of the firm.

Action-enabling Recommendation – that ensures that the findings of the audit form a strong basis for change and improvement in the company.

Environmental audits

An environmental audit can be defined as: '…a management tool, comprising a systematic, objective assessment of how well an entity is performing with the aim of safeguarding the environment by enhancing management control of environmental practices including compliance with appropriate legislation and regulations.' Thus environmental audits assess how well the entity performs in safeguarding the environment and whether the entity complies with its environmental policies.

An environmental audit may be performed by the entity's external auditors, or the internal auditors, or external environmental experts. A typical environmental audit will involve an assessment of all impacts of the entity's activities on the environment, including:

- compliance with environmental regulations, such as pollution of land, water and air
- waste disposal
- recycling policies and

- sourcing of raw materials.

The environmental auditor will determine the environmental policies that the organisation has in place, and assess the entity's performance based on measurable performance criteria.

4.0 Conclusion

Transnational audits are necessary for entities whose activities cut across national borders. Though transnational audits have their peculiar problems, for example, difference in regulation and oversight of auditors in different jurisdictions, the FoFs is doing a lot to standardize the practice of transnational audits.

Social and environmental audits are essential in engaging an entity's compliance with their social and environmental policies as well as compliance with regulations. Companies have social and environmental responsibilities because they create social and environmental problems.

5.0 Summary

This unit has discussed the concept of transnational audits, its features and the guidance/efforts of Forum of Firms (FoF) targeted at improving the quality of transnational audits. The unit also treated social and environmental audits: the reasons for social and environmental concerns, social and environmental policies and the need to give assurance on compliance with these policies and legislation.

6.0 Tutor-marked assignment

1. Discuss the features and challenges of transnational audits

2a. Explain the terms: Social audits and Environmental audits.

b. Discuss the objectives of social audits and environmental audits.

7.0 References/further reading

1. Enahoro, J.A (2012). Accounting for the environment and natural resources. Ilishan-Remo: Babcock University Press

2. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd.
3. ACCA Study Text on Advanced Audit and Assurance. UK: BPP Learning Media.