



Bachelors of Business Management

Code: ACC 411

Title: Principles of Auditing

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Course Content

ACC 411: PRINCIPLES AUDITING

Contact hours: 42

Pre-requisites: ACC 322

Purpose To introduce the learner to auditing practice and its application in accounting profession

Expected Learning Outcomes of the Course

By the end of the course unit the learners should be able to:-

- i) Explain the purpose and objectives of auditing
- ii) Explain the duties and rights of an auditor
- iii) Describe types of audit
- iv) Explain stages involved in an audit a

Course Content

Introduction to nature and purpose of auditing; purpose and objectives of independent audit; Engagement and removal of an auditor; Types of audit; internal, external; Stages in an audit; Audit planning and audit working papers; Audit evidence; introduction to substantive tests, audit reports, letter of presentation; Auditing a computerized system

Teaching / Learning Methodologies: Lectures and tutorials, Group discussion, Demonstration, Individual assignment

Course Assessment

Examination - 70%; Continuous Assessment Test (CATS) - 20%; Assignments - 10%; Total - 100%

Recommended Text Books:

- Kumar Ravinder (2008), *Auditing: Principles And Practice*, Prentice-hall Of India Pvt Ltd
- A. H. Millichamp (2002), *Auditing 8th Ed*, Thomson LearningBowersox, Donald and M. Bixby Cooper (2002), *"Principles of Auditing,"* New York, NY:

Text Books for further Reading:

- Ray Whittington, (2003) *Principles of Auditing and Other Assurance Services*, McGraw-Hill College.
- William C. Boynton, Raymond N. Johnson and Walter G. Kell, (2001), *Modern Auditing*, Wiley

Chapter One – Introduction to Auditing

Introduction

Definition

The Definition for Audit and Assurance Standard AAS-1 by the Institute of Chartered Accountants of India(ICAI) -- "Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

The general definition of an audit is an evaluation of a person, organization, system, process, enterprise, project or product. The term most commonly refers to audits in accounting, but similar concepts also exist in project management, quality management, and energy conservation.

This topic attempts at explaining the reasons as to why auditing exist as a specialized discipline. The chapter further explains the need for the audit. It also explains the objectives of auditing besides explaining the parties who are interested in financial statements of any business organisation.

Agency Theory and Auditing

An agency relationship arises whenever one or more individuals called principals use other people or individual/s called agents to perform some services on their behalf. The principals delegate decision making authority to the agents. In case of public limited company, agency relationship may take two forms:

- Agency Relationship Between Shareholders and The Management
- Between shareholders and Creditors

More often than not conflicts may arise between the principals and agents.

Public companies are owned by shareholders but are managed by directors who in turn employ the top management to manage the affairs of the company on their behalf.

The shareholders and other stakeholders are interested in knowing whether their hard earned resources are managed in more transparent and profitable manner. The management reports the affairs of the business through financial statements such as:

- i. Income statement
- ii. Cash flow statement and
- iii. Statement of financial position

The authenticity of these financial statements must be ascertained by an independent and qualified party. This party happens to be the auditor.

Agency Relationship between Shareholders and The Management

The shareholders are the real owners of the company through equity capital contribution. However, they may not be involved directly in the day to day running of affairs of the business. The shareholders may not have the necessary skills and expertise to manage the affairs of the business. On the hand they are likely not to have the time needed to run the day to affairs of the business. As a result, they appoint other parties to manage the affairs of the company or business on their behalf. The shareholders are principals while the management team is the agents.

Conflict between Shareholders and the Management

There is the assumption that the managers and shareholders left on their own will each attempt to act in their own self interest. The managers are likely to pursue goals which do not maximize the shareholders wealth. The goals would only serve the interest of the managers and therefore conflict the shareholders' goals. Conflicts of interest may, for instance arise from the following cases:

- Managers awarding themselves hefty pay hikes
- Managers taking expensive trips and holidays
- Managers arranging mergers and take – over for their benefits
- Managers arrange very attractive retirement for themselves
- Discriminatory employment practices
- Luxurious lifestyles by managers fully paid by the business etc.

Agency Relationship between shareholders and Creditors

The creditors are contributors of debt capital. They are not in any way involved in the day to day running of the business. After the provision of debt finance, the shareholders are expected to

manage the finances along with the management on behalf of the creditors. The creditors therefore constitute the principals while the shareholders are the agents

Conflict between Shareholders and the Creditors

Creditors lend to the firm at a rate which depends on the riskiness of the firm as perceived by the creditors. The creditors provide the firm the finances for a specific time period. A lot can happen during that period

The shareholders through the management may, for instance take up projects with a higher risk than was anticipated when the finances were granted. On the other hand, the shareholders may take up projects that have not agreed upon. Should these project fail the creditors stand to lose a great deal.

Users of Financial Statements

Financial statements usually three forms namely: Income statement, Cash flow statement and Statement of financial position. The financial statements may be produced quarterly, semi – annually or annually. The company's Act recommends that they must be produced annually. There are quite a number of parties who are interested in the financial statements. Their interests differ from one party to another. Specifically the following are some of the users of financial statements:

- Owners or shareholders both current and potential
- Actual lenders and lenders potential
- Current and potential employees
- Current and potential customers
- Current and potential short and long term suppliers of goods and debt
- The government and its agencies
- Consultants
- Financial analysts
- General public
- Consumer watch groups
- Trade unions etc.

The Purpose of Audit

When the managers report to the owners or shareholders and stakeholders there is the likelihood that they will try to paint a picture that they delivered as agreed with the stakeholders or shareholders. The reports are likely to:

- Have misstatements
- Have misleading information
- Contain Errors
- Conceal fraud
- Fail to disclose all relevant information

All these problems and other may be solved by appointing an independent qualified auditor to go through the reports and financial statements.

Most business have expanded to extent that they very large operating as multinational. The complex operations of these multi – nationals need to be summarized by a very qualified person who is conversant with accounting producers across boundaries. The financial statements are required to conform to international accounting standards issued by IASC. It is of paramount importance that the financial statements are scrutinized and examined to ascertain that they conform to the requirement of the international accounting standards.

Objectives of Auditing

There are two main objectives of auditing: Primary objective and Subsidiary objective.

The primary objective of any audit is to produce a report regarding the truth and fairness of the company's financial statements so that any users of these statements can belief in them in totality. The primary goal of the audit is to enable the auditor to just say "*these statements show a true and fair view*" or not.

The other objectives referred to as subsidiary include:

- i. To detect errors and fraud
- ii. To prevent errors and fraud
- iii. To provide spin off effects and services such accounting, taxation and others

The Auditor and Other Services

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

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

Qualities of an Auditor

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

- i. Competence
- ii. Independence and
- iii. Integrity

These qualities are explained here below.

Competence

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

Independence

An independent auditor is who cannot give biased opinion. Total independence is likely not to be achieved but independence is important. Independence is the freedom from conditions that threaten the ability of the audit activity to carry out audit responsibilities in an unbiased manner. To achieve

the degree of independence necessary to effectively carry out the responsibilities of the audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Integrity

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

Advantages and Disadvantages of Auditing

Advantages of an Audit

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

Disadvantages of an Auditor

- i. It is an expensive operation because audit fees and audit expenses are usually too high for small companies.
- ii. If the report arising out of audit is bad, it can lead to the failure of the business (a qualified report).
- iii. An audit may not be ideal for small business whose transactions are too few.
- iv. An audit may not in most cases be in the interest of the owners, especially if they are the managers in which case they may end up frustrating the entire process.

Review Questions

QuestionOne

- a. Explain the term auditing
- b. What are the principles of auditing?
- c. What are the objectives of auditing
- d. Explain the qualities of an auditor

QuestionTwo

There are a number of people and groups that are interested in the company's books of accounts and records.

List down the users of the financial statement explaining clearly the interest of each group

QuestionThree

What are the advantages of auditing?

Question Four

Auditors provide auditing and other services. Explain the other services that auditor can provide to his client

Chapter Two – The Auditor and the Companies Act Cap 486

Introduction

Statutory audits are carried out as guided by the rules set out in the Companies Act Cap 486. The topic outlines the rules on the requirement for a company to follow. It outlines the rules on the auditor's appointment, auditor's resignation and dismissal, his remuneration and who qualifies to be a company's auditor.

Auditors' Appointment and Remuneration

Section 159 of the companies Act Cap 486 states:

(1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

(2) Notwithstanding the provisions of subsection (1), at any annual general meeting a retiring auditor, however appointed, shall be deemed to be reappointed without any resolution being passed unless -

- a) he is not qualified for reappointment; or*
- b) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or*
- c) he has given the company notice in writing of his unwillingness to be reappointed:*

Provided that where notice is given of an intended resolution to appoint some person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be deemed to be automatically reappointed by virtue of this subsection.

(3) Where at an annual general meeting no auditors are appointed or are deemed to be reappointed, the registrar may appoint a person to fill the vacancy.

(4) The company shall, within seven days of the registrar's power under subsection (3) becoming exercisable, give him notice of that fact, and, if a company fails to give notice as required by this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

(5) Subject as hereinafter provided, the first auditors of a company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until the conclusion of that meeting:

Provided that–

- i. the company may at a general meeting remove any such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting; and*
- ii. if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.*

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

(7) (a) The remuneration of the auditors of a company–

- i. in the case of an auditor appointed by the directors or by the registrar may be fixed by the directors or by the registrar as the case may be;*
- ii. subject to subparagraph (i), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.*

(b) For the purposes of this subsection, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration"

Section 159 of the Companies' Act cap 486 states clearly that the following should be done:

- i. appoint an auditor during the company must annual general meeting
- ii. a retiring auditor who happens to be re – appointed is duly appointed
- iii. the registrar of companies have power to appoint an auditor if the company fails to appoint one during their annual general meeting
- iv. the must notify the registrar of companies within seven days that they were unable to appoint an auditor, failure to which the company and any officer who failed is liable to a default fine
- v. the first auditors of the company may be appointed by the directors of company before the first AGM
- vi. the remuneration of the auditors will be fixed by whoever appoints him or her

Resolution Relating to Appointment and Removal of Auditors

Section 160 of the Companies Act Cap 486 states

(1) Special notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor or providing expressly that a retiring auditor shall not be reappointed.

(2) On receipt of notice of such an intended resolution as aforesaid, the company shall forthwith send a copy thereof to the retiring auditor (if any).

(3) Where notice is given of such an intended resolution as aforesaid and the retiring auditor makes with respect to the intended resolution representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company, the company shall, unless the representations are received by it too late for it to do so—

and if a copy of the representations is not sent as aforesaid because received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting:

Provided that copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the court is satisfied that the rights conferred by this section are being abused to secure needless publicity for defamatory matter; and the court may order the company's costs on an application under this section to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.

(4) Subsection (3) shall apply to a resolution to remove the first auditors by virtue of subsection (5) of section 159 as it applies in relation to a resolution that a retiring auditor shall not be reappointed.

In conclusion:

- i. Every limited company must appoint an auditor to audit its books of accounts.
- ii. The directors have powers to fill a casual position or vacancy
- iii. The first auditors may be filled by the directors before holding the first annual general meeting.
- iv. In case the directors fail to appoint the first auditors, the shareholders can appoint in an AGM where the books of accounts are not being presented.
- v. The company must notify the registrar of companies within one week of the failure to appoint an auditor.

Disqualifications for Appointment as Auditor

Section 161 of Companies Act Cap 486 states:

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

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

(i) an officer or servant of the company;

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

(iii) a body corporate:

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

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

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

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

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

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

Right of Access to Books and Attend Meeting

Section 162 stipulates that:

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

(2) The auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(4) The auditors of a company shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

Section 162 of the Companies' Act Cap 486 clearly states the following:

- i. The auditors have the responsibility of making the auditors reports regarding all the books examined by them thereby expressing their opinion on the truth and fairness view regarding the books
- ii. The auditor must be presented during the annual general meeting of the company
- iii. The auditor must be give unrestricted accessed to books of accounts at all times as he/she may need
- iv. It is the right of the auditor to attend the annual general meeting (AGM) of the company
- v. It is the right of the auditor to be heard in the annual general meeting (AGM) of the company

Review Questions

QuestionOne

- a. Explain the tenure of an auditor
- b. Explain how an auditor can be appointed as stipulated in Companies Act Cap 486
- c. Explain who is disqualified to be appointed as an auditor as stipulated in Companies Act Cap 486
- d. Explain the rights of the auditor to access books as stipulated in Companies Act Cap 486

QuestionTwo

The directors of Kijana Mdogo limited, a company just formed a few months ago, have consulted you in writing with a view of engaging you as their first auditors. In their letter you notice the following statements

“Your duties and rights will be determined by the board of the company strictly. In addition the directors retains exclusively the right to dismiss you without necessarily explaining the reasons for their actions”

Required

- a. Describe your duties as an auditor of Kijana Mdogo Limited
- b. What should be your relationship as an auditor and the directors of the company
- c. Explain your rights as an auditor as stipulated in Companies Act Cap 486
- d. What is your position regarding the exclusive rights of the directors to dismiss you

QuestionThree

The appointment, duties and rights of the a company’s auditor are dealt with in Companies Act Cap 486

Required

- a. Explain how he may be appointed
- b. The statutory duties of the auditor
- c. The statutory rights of the auditors

Chapter Three – The Accounting Records and the Companies Act

Introduction

The chapter details the companies Act Cap 486 requirements on the keeping of accounting records and books by incorporated companies. The accountant and the auditor must familiarize himself or herself with requirements before he/she carries out the audit work. The auditor must ascertain that the directors of the company have complied with all the necessary rules and requirements of the companies Act. It the responsibility of the directors to keep proper books of accounts. Proper books of accounts must comply with rules and regulation as set out in the companies Act and the relevant International Accounting Standards.

Books of Accounts and Audit

Section 147 of the companies Act Cap 486 states:

- (1) *Every company shall cause to be kept in the English language proper books of account with respect to—*
 - (a) *All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;*
 - (b) *All sales and purchases of goods by the company;*
 - (c) *The assets and liabilities of the company;**Provided that in respect of an existing company the requirement that such books of account shall be kept in the English language shall not have effect until after the expiration of a period of two years from the date of the commencement of this Act.*
- (2) *For the purposes of this section, proper books of account shall be deemed not to have been kept with respect to the matters aforesaid if there are not kept such books as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions.*
- (3) *(a) The books of account shall be kept at the registered office of the company or, subject to the provisions of paragraph (b), at such other place as the directors think fit, and shall at all times be open to inspection by the directors.*
(b) The books of account shall only be kept at a place outside Kenya with the consent of the registrar and subject to such conditions as he may impose; and if the books of account are kept at a place outside Kenya there shall be sent to, and kept at a place in, Kenya, and be at all times open to inspection by the directors, such accounts and returns with respect to the business dealt with in the books of account so kept as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding six months.

- (4) *If any person being a director of a company fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own wilful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be liable to imprisonment for a term not exceeding twelve months or to a fine not exceeding ten thousand shillings or to both:*

Provided that—

- (1) *in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty; and*
- (2) (ii) *A person shall not be sentenced to imprisonment for such an offence unless, in the opinion of the court, the offence was committed willfully.*

In conclusion Section 147 of the companies Act Cap 486 states clearly the following:

- i. The company should keep proper books of account in English language. The books should be expressed in monetary terms
- ii. The books should reflect a true and fair view of the transactions under during the period in question
- iii. The books should be kept in the registered office of the company and any other place that the directors may deem fit
- iv. If the books are kept outside Kenya, the registrar must be informed
- v. If the directors or any other officer fails to keep the books of accounts the director or any officer shall be liable a fine of not exceeding ten thousands or a jail term not exceeding twelve months or both

Income Statement and Statement of Financial Position

Section 148 of the companies Act Cap 486 states:

- (1) *The directors of every company shall, at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year, lay before the company in general meeting a profit and loss account or, in the case of a company not trading for profit, an income and expenditure account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months or, in the case of a company carrying on business or having interests abroad, by more than twelve months:*

Provided that, if the registrar for any special reason thinks fit to do so, he may—

- (i) in the case of any company, extend the period of eighteen months aforesaid, and in the case of any company and with respect to any year, extend the periods of nine and twelve months aforesaid; and*
 - (ii) in the case of any company, permit the account to be laid before the company after the end of the calendar year.*
- (2) *The directors shall cause to be made out in every calendar year, and to be laid before the company in general meeting, a balance sheet as at the date to which the profit and loss account or the income and expenditure account, as the case may be, is made up.*
- (3) *If any person being a director of a company fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be liable to imprisonment for a term not exceeding twelve months or to a fine not exceeding ten thousand shillings or to both:*

Provided that—

- (i) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty; and*
- (ii) a person shall not be sentenced to imprisonment for such an offence unless, in the opinion of the court, the offence was committed wilfully.*

In conclusion, Section 148 of the companies Act Cap 486 states clearly:

- i. It is the sole responsibility of the directors of the company to prepare financial statements
- ii. It is the sole responsibility of the directors of the company to lay these financial statements during the Annual General Meeting
- iii. If the directors fail to take necessary actions regarding preparation and laying down these financial statements, then they shall be liable to a fine not exceeding ten thousands or a jail term not exceeding twelve months or both

General Provisions to Contents and Form of Financial Statements

Section 149 of the companies Act Cap 486 states that:

- (1) *Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.*

- (2) *A company's balance sheet and profit and loss account shall comply with the requirements of the Sixth Schedule, so far as applicable thereto.*
- (3) *Save as expressly provided in the following provisions of this section or in Part III of the Sixth Schedule, the requirements of subsection (2) and the said Schedule shall be without prejudice either to the general requirements of subsection (1) or to any other requirements of this Act.*
- (4) *The registrar may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Act as to the matters to be stated in a company's balance sheet or profit and loss account (except the requirements of subsection (1)) for the purpose of adapting them to the circumstances of the company.*
- (5) *Subsections (1) and (2) shall not apply to a company's profit and loss account if—*
(a) the company has subsidiaries; and
(b) the profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company and—
(i) complies with the requirements of this Act relating to consolidated profit and loss accounts; and
(ii) shows how much the consolidated profit or loss for the financial year is dealt with in the accounts of the company.
- (6) *If any person being a director of a company fails to take all reasonable steps to secure compliance as respects any accounts laid before the company in general meeting with the provisions of this section and with the other requirements of this Act as to the matters to be stated in accounts, he shall, in respect of each offence, be liable to imprisonment for a term not exceeding twelve months or to a fine not exceeding ten thousand shillings or to both: Provided that—*
(i) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the said provisions or the said other requirements, as the case may be, were complied with and was in a position to discharge that duty; and
(ii) a person shall not be sentenced to imprisonment for any such offence unless, in the opinion of the court, the offence was committed wilfully.
- (7) *For the purposes of this section and the following provisions of this Act, except where the context otherwise requires -*
(a) any reference to a balance sheet or profit and loss account shall include any notes thereon or document annexed thereto giving information which is required by this Act and is thereby allowed to be so given; and

(b) any reference to a profit and loss account shall be taken, in the case of a company not trading for profit, as referring to its income and expenditure account, and references to profit or to loss and, if the company has subsidiaries, references to a consolidated profit and loss account shall be construed accordingly.

In general Section 149 of the companies Act Cap 486 states clearly the following

- i. Statement of financial position should give true and fair view of the state of affairs of the business at the end of the accounting period
- ii. A company's statement of financial position and the income statement should comply with the requirements of the Sixth Schedule of the companies Act Cap 486.
- iii. Any person, officer or director who fails to comply with the requirements of the companies' Act Cap 486 is liable to a jail term of twelve months or ten thousands or both

Obligation to lay group accounts before holding company

Section 150 of the companies Act Cap 486 states that:

- (1) *Where at the end of its financial year a company has subsidiaries, accounts or statements (in this Act referred to as group accounts) dealing as hereinafter mentioned with the state of affairs and profit or loss of the company and the subsidiaries shall, subject to subsection (2), be laid before the company in general meeting when the company's own balance sheet and profit and loss account are so laid.*
- (2) *Notwithstanding anything in subsection (1)–*
 - (a) group accounts shall not be required where the company is at the end of its financial year the wholly owned subsidiary of another body corporate incorporated in Kenya; and*
 - (b) group accounts need not deal with a subsidiary of the company if the company's directors are of opinion that–*
 - (i) it is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or*
 - (ii) the result would be misleading, or harmful to the business of the company or any of its subsidiaries; or*
 - (iii) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking; and*

if the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required:

Provided that the approval of the registrar shall be required for not dealing in group accounts with a subsidiary on the ground that the result would be harmful or on the ground of the difference between the business of the holding company and that of the subsidiary.

- (3) *If any person being a director of a company fails to take all reasonable steps to secure compliance as respects the company with the provisions of this section, he shall, in respect of each offence, be liable to imprisonment for a term not exceeding twelve months or to a fine not exceeding ten thousand shillings or to both:*

Provided that—

(i) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the requirements of this section were complied with and was in a position to discharge that duty; and

(ii) a person shall not be sentenced to imprisonment for an offence under this section unless, in the opinion of the court, the offence was committed wilfully.

- (4) *For the purposes of this section a body corporate shall be deemed to be the wholly owned subsidiary of another if it has no members except that other and that other's wholly owned subsidiaries and its or their nominees.*

Form of group accounts

Section 151 of the companies Act Cap 486 states that:

1. *Subject to subsection (2), the group accounts laid before a holding company shall be consolidated accounts comprising -*
 - (a) *a consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;*
 - (b) *a consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.*
2. *If the company's directors are of opinion that it is better for the purpose—*
 - a) *of presenting the same or equivalent information about the state of affairs and profit and loss of the company and those subsidiaries; and*
 - b) *of so presenting it that it may be readily appreciated by the company's members,*

the group accounts may be prepared in a form other than that required by subsection (1), and in particular may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

3. *The group accounts may be wholly or partly incorporated in the company's own balance sheet and profit and loss account.*

Contents of group accounts

Section 152 of the Companies Act Cap 486 states that:

- (1) *The group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.*
- (2) *Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall, unless the registrar on the application or with the consent of the holding company's directors otherwise directs, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.*
- (3) *Without prejudice to subsection (1), the group accounts, if prepared as consolidated accounts shall comply with the requirements of the Sixth Schedule, so far as applicable thereto, and if not so prepared shall give the same or equivalent information:*

Provided that the registrar may, on the application or with the consent of a company's directors, modify the said requirements in relation to that company for the purpose of adapting them to the circumstances of the company.

Financial year of holding company and subsidiary

Section 153 of the Companies Act Cap 486 states that:

- (1) *A holding company's directors shall ensure that except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year.*
- (2) *Where it appears to the registrar desirable for a holding company or a holding company's subsidiary to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that*

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

Accounts and auditors' Report to be Annexed to Balance Sheet

Section 156 of the Companies Act Cap 486 states that:

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

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

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

Directors' report to be attached to balance sheet

Section 157 of the Companies Act states that:

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

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

- (3) *If any person being a director of a company fails to take all reasonable steps to comply with the Provisions of subsection (1), he shall, in respect of each offence, be liable to imprisonment for a term not exceeding twelve months or to a fine not exceeding ten thousand shillings or to both:*

Provided that—

- (i) in any proceedings against a person in respect of an offence under subsection (1), it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the provisions of that subsection were complied with and was in a position to discharge that duty; and*
- (ii) a person shall not be liable to be sentenced to imprisonment for such an offence unless, in the opinion of the court, the offence was committed wilfully.*

Review Questions

Question One

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

Question Two

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

Question Three

The Companies' Act Cap 486 lays down certain requirements in relation to the accounting records which every company shall keep. You are required to state the records that must maintained and state the information to contained in these records

Chapter Four – The Auditor and the Professional Ethics

Introduction

Auditing is usually carried out by qualified accountant who must be registered as accountants. Accountancy is a profession and as such must be guided by code of ethics and rules of conduct. The rules of conduct are usually found professional handbooks issued by member's body and issued to all registered members. This chapter will attempt at explaining what a profession is, rules that guide professions among other matters.

Profession

Most dictionaries describe and define *profession* as a calling or vocation involving some branch of learning. Accountancy involves a body of knowledge. Accountants must tried in various areas .The idea of a profession rests on the following premises

- A recognizable discrete body of knowledge
- An educational process
- A system of examinations
- A system of licensing practitioners
- A sense of responsibility to the society
- A code of ethics
- A set of technical standards

General Rules of Ethics

Professional accounts are required to observe proper standards of professional conduct whether or not the standards required are written in the rules or are unwritten. The professional accountants are specifically required to refrain from misconduct which is difficult to precisely but which includes any act or default which is likely to bring discredit on himself, his professional body or the profession generally

Several general observations are worth mentioning. These include among others:

- i. Professional independence – this is vitally important. This is much of the attitude or state of mind rather than a set of rules.

- ii. Integrity – Integrity is vital and simply includes honesty, uprightness, probity rectitude and moral soundness
- iii. Accountants must not only be people of integrity and independence; they must also be seen to be so. Any interest such as owning shares in a clients company which might diminish the accountant's objectivity must be avoided
- iv. When an accountant has difficult or is unsure of what course of conduct to follow, he should consult his professional body or take legal advice. If in doubt always seek advice

Independence

The rule of the thumb is that the accountant must approach his work with integrity and objectivity. He must approach his in a spirit of independence of mind.

Factors That Can Compromise The Auditor's Independence

a. Fees

It is undesirable that the auditor derives a huge proportion of his income from one single client. If this happens the auditor is likely to be compromised by this client

b. Personal Relationships

It is desirable to avoid personal relationships with the client and his staff. Conflict of interest is likely to arise in cases where there exist such relationships

c. Beneficial Shareholdings

In general, partners, their spouses and minor children should avoid owning shareholding the clients companies. Staff members who own shareholding in companies should not be engaged in the audit of these companies.

d. Loans to and from Clients

The auditor should avoid granting or receiving loans and other such inducements from the companies for which they audit.

e. Acceptances of goods / services from Clients

Goods and service should only be accepted only to the extent that they do not threaten the independence of the auditor. Acceptance of undue hospitality may pose threats of independence.

f. Commissions

Many auditors receive commissions from financial institutions when they act for the clients. It should be seen that any advice should be in the best interest of the client and not vice versa. The client should be informed in writing that commission will be received and as far as possible on what terms.

Conflict of Interest

Conflict of interest is like to arise between the auditor and his client. Specific example conflict of interest may include among others:

- a. Provision of other service to audit clients
- b. Preparation of accounting records
- c. Receivership, Liquidation and audits

Advertising

The rules of professional conduct prohibit auditors from advertising for their services as a resort. If a company wishes to appoint an auditor, it is usually the director who approaches one and requests him to place a quotation for the provision of his services.

Publicity

In the past, auditors and accountants were required to be anonymous in public matters. The rules are now less restrictive but there are still some prohibitions. A general prohibition is on any publicity which would bring the auditor, his professional body or the prohibition, into dispute. Presumably, an auditor appearing on talk show and introducing himself as an accountant is acceptable. Examples of acceptable publicity include:

- Advertizing for staff, partners or sub – contract work
- Advertizing on behalf of a client
- Publicizing the opening of a new branch or premises
- Publishing literature

- Entries in a business directory

Remuneration

The normal way or basis of charging for professional work is on the basis of the time spent on the client premises or work.

It depends on the nature of the appointment.

- Those appointed by the Board of Directors, it is the responsibility of the same Board to take care of their fees and other expenses.
- Those appointed by the shareholders, it is the responsibility of the shareholders to determine the fee.
- Those appointed by the Registrar of Companies – payment is fixed by the Registrar in consultation with the Directors.
- In case of a retiring officer payment will be done as in previous years.
- In case of extra work, they will get extra remuneration by the very employer.
- In case of illegal removal of the auditor, he is entitled to a remuneration of one full year by the employer.

Insider Dealing

Insider dealing is illegal. It is also contrary to ethical rules. Individuals who during their course of work come across unpublished price sensitive data and information are prohibited to use such information for undue advantage. Auditors may have access to information that only they have. They are legally not allowed to use this information at the detriment of the other members of the public.

Review Questions

Question One

- a. What are the characteristics of a profession?
- b. What general ethical rules are there?
- c. What should the auditor do if faced with ethical dilemma?
- d. Enumerate the guidelines to independence
- e. What is meant by the term insider dealing

Question Two

You are employed by a firm of Certified Public Accountants, Nora & Norah CPA and you recently received an invitation to take part in a training course with all the partners and staff in hotel in Mombasa. Much to your surprise you find on the main street leading to the hotel a banner inscribed with the following words

Nora & Norah CPA

Training week 3rd December – 9th December 2011

Required

- a. State, with reasons, what action your firm should take in the matter described above
- b. Explain to the management of the hotel why accounting firms only advertise their services in a restricted manner.

Question Three

You are a qualified accounting technician and a member of a small team responsible for the audit of a limited company. During the course of the audit, a junior member of the team who was recently commenced training raises a number of questions with you.

Required

In respect of each of the following queries outline in note form the answer which you would give to the new trainee

- a. What is an audit?

- b. Why are you reading the minutes of the directors' meetings and what do you expect to find of value to the audit
- c. Why do you have a set list of work to do on the audit? Why can't you select the work to be done where you think that there has been fraud?

Question Four

It has been suggested that the most important matter affecting the credibility of the auditor is that of "independence"

Required

- a. Discuss, giving examples, matters other independence that affect the credibility of the auditor
- b. Comment on the following situations in the context of independence of the auditor, showing clearly the principle involved
 - i. The audit manager in charge of the audit assignment of Ambale Limited holds 1 % of the share capital but the audit partner holds none
 - ii. An audit partner James Kimani of Kimani&Onyango CPA is a personal friend of the chief accountant of Harfel Company Limited. The chief accountant is not a shareholder neither a director of Harfel Company Limited. The audit partner is not involved in the audit of the company
 - iii. The audit fee receivable from Janese Limited by Omali& Mohammed CPA, is Kshs 1000,000. The total fee income of the audit firm amounts to Kshs 4,500,000 annually.
 - iv. The audit senior in charge of the audit of Margur Bank Limited has a personal loan of Kshs 2000,000 from the bank of which she is paying at an interest rate of 10% while the bank's lending rate is 18% per annum

Chapter Five – Engagement Letters

Introduction

This topic attempts at explaining the procedure and require of engaging auditor. Before starting any professional engagement, it is important that the professional agree in writing, the precise scope and the nature of the work to be done. This is to make sure that both the client and the professional are properly. The accountant is required to agree with the client in writing, the scope and nature of the auditing work to be done. This is usually done an engagement letter. There exists an auditing guideline on engagement letters. This is auditing guideline is Kenyan Auditing Guideline number Twelve.

Purpose of Engagement Letters

Paragraph 2 of Kenyan Auditing Standard 1 states “The auditor should adequately plan, control and record his work”. The auditing guideline gives guidance on one of the procedures to be followed before commencement of audit. The purpose of an engagement letter is to define clearly the extent of the auditor’s responsibilities and to minimize the possibility of any misunderstanding between the client and the auditor.

The engagement letter provides a written confirmation of the auditor’s acceptance of his/her appointment, the scope of the audit work and the form of his/her report. If an engagement letter is not sent to clients, both new and existing, there is scope for argument about precise extent of the respective obligation of the client and its directors and the auditors. Furthermore, the auditor may find that he has entered into an implied contract arising either from article of association or by virtue of conduct arising from practices that he has adopted over a period of time.

Specifically the purposes of an engagement letter can be simplified as under:

- To define precisely the extent of the auditor’s responsibilities
- To minimize the possibility of misunderstanding between the auditor and the client
- To accept formally any verbal arrangements and agreements
- To inform and educate the client regarding each parties responsibilities and duties
- If the terms of engagement are agreed in writing, there may be an implied contract arising out of the Article of Association of previous engagement

Procedures

The agreement of an engagement letter is in the interest of both the auditor and the client. Therefore the contents of an engagement letter should be discussed and agreed with the management before it is sent and preferably prior to the audit appointment. In case of a company incorporated under the companies Act Cap 486, the term management should be taken to mean the directors of the company and persons acting with similar authority.

The auditor should send an engagement letter to all new clients soon after his appointment as auditor and, in any event, before the commencement of the first audit assignment. He should also consider sending an engagement letter to existing clients to whom no letter has previously been sent as soon as suitable opportunity presents itself.

Where an auditor is engaged by a client that has subsidiary companies, a separate letter should be sent by the auditor to the board of directors of each company which he is auditing. However, if the terms of the engagements are common, one letter may be sent relating to group as a whole. In the later case, the auditor's letter should identify the group companies for which he is appointed as auditor, and the directors of the holding or parent company should be requested to forward the letter to the board of director of the subsidiary companies concerned. The auditing should request confirmation from each board that the terms of engagement letter are accepted. Where more than one firm of auditors is involved in the audit of the group, the respective responsibilities of the parent or holding company auditor and the subsidiary auditors should be clearly defined.

Where there are joint auditors, the audit engagement should be explained in similar terms by each auditor. The auditors should agree whether joint or separate letters should be sent to the client. Separate letters would normally need to be sent where other services are provided.

Once it has been agreed by the client, an engagement letter will, if it so provides, remain effective, from one audit appointment to another, until it is replaced. However, the engagement letter should be reviewed annually to ensure that it continues to reflect the client's circumstances. If a change has taken place, including a significant change in management which materially affects the scope or understanding of the audit, the auditor should discuss the matter with the management and where appropriate send a revised engagement letter.

Contents of an Engagement Letter

The engagement should outline clear the client's statutory duties and the auditor's statutory and professional responsibilities and duties. The client's statutory responsibilities include keeping proper books of accounts as stipulated by Companies Act Cap 486 section 147. The auditor's statutory responsibilities include preparing audit reports as stipulated in the Companies Act Cap 486 section 156 and 162 and other provisions. The auditor's professional responsibilities include accounting and advising the client on compliance to standards, regulation and the necessary legislation. The actual contents are explained here below.

1. Responsibilities and scope of the Audit

The letter should explain the principal statutory responsibility of the client and the statutory and professional responsibility of the auditor. In case of a company, it should be indicated that it is the statutory responsibilities of the client to main proper accounting records and to prepare financial statements which a true and fair view and comply with the Companies Act Cap 486 and other relevant legislation and regulations. It should also indicated that the auditor's statutory responsibilities include making a report to the members stating whether in his opinion the financial statements gives a true and fair view and whether they comply with Companies Act Cap 486 and other regulations and legislation.

It should be explained that the auditor has an obligation to satisfy himself whether or not the director's report contains any matter that are inconsistent with the audited financial statements. Furthermore, it should be indicated that the auditor has a professional responsibility to report if the financial statements do not comply with in any material respect with Internal Accounting Standards.

The scope of the audit should be explained explicitly. In this connection, it should be pointed out that the audit will be conduct in accordance with approved Auditing Guidelines and regard to relevant Auditing Guidelines. It should be indicated that:

- i. The auditor will receive an understanding of the accounting system in order to assess its adequacy as a basis for the preparation of the financial statements
- ii. The auditor will expect to obtain relevant and reliable evidence sufficient enough to enable him draw reasonable conclusion therefrom.

- iii. The nature and extent of the tests will vary according to the auditor's assessment of the accounting system and where he wishes to place reliance upon it, the system of internal system.
- iv. The auditor will report to the management any significant weakness in, or observation on, the client's system which come to his notice and which he thinks should be brought to the management's attention.

Where appropriate, reference should be made to recurring special arrangement concerning audit. These could include arrangements in respect of internal auditors, divisions, overseas subsidiaries, other auditors and (in the case of a small business managed by directors who are the major shareholders) significant reliance of supervision by the directors.

2. Representation by Management

Where appropriate it should be indicated that prior to the completion of the audit, the auditor may seek written representation from management on matters having a material effect on the financial statements.

3. Irregularities and Fraud

The responsibility for the prevention and detection of irregularity and fraud rests with the management and this responsibility is fulfilled mainly through the implementation and continued operation of an adequate system of internal control. The engagement letter should make this clear. Furthermore, it should be explained that the auditor will endeavour to plan his audit so that he has reasonable expectation of detecting material misstatements in the financial statements resulting from irregularities or fraud, but that the examination should not be relied upon to disclose irregularities and frauds which may exist.

4. Accounting and Taxation Services

The auditor may undertake, for the company, services in addition to carrying out his responsibilities as an auditor. An engagement letter should adequately describe the nature and scope of those services. In this case of accounting services, the letter should distinguish the accountant's and the client's responsibilities in relation to them and the day to day book – keeping, the maintenance of all

accounting records and the preparation of financial statements. Preferably this should be done in a separate letter but such services may form the subject to a section in the audit engagement letter.

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

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

5. Fees

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

6. Agreement of Terms

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

Example of Engagement Letter

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

To the directors of XYZ Ltd

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

1.0 Audit

- 1.1 As directors of the above company, you are responsible for maintaining proper accounting record and preparing financial statements which give a true and fair view and comply with the companies Act Cap 486. You are also responsible for making available to us, as and when required, all the company's accounting records and all other records and related information, including minutes of all management and shareholders' meeting
- 1.2 We have statutory responsibility to report to the members whether in our opinion the financial statements give a true and fair view of the state of the company's affairs and of the profit and loss for the year and whether they comply with the companies Act cap 486. In arriving at our opinion, we are required to consider matters, and to report on any in respect of which we are not satisfied.
- a. Whether proper accounting records have been kept by the company
 - b. Whether the company's statement of financial position and income statement are in agreement with the accounting records
 - c. Whether we have obtained all the information and explanation which we think necessary for the purpose of our audit
- 1.3 We have professional responsibility to report if the financial statements do not in any material respect with International Auditing Standards and Kenyan Auditing Standards
- 1.4 Our audit will be conducted in accordance with Auditing Guidelines issued by Institute of Certified Public Accountants of Kenya (ICPAK) and will have regard to relevant Auditing Guidelines. Furthermore, it will be conducted in such tests of transactions and of the existence, ownership and valuation of assets and liabilities as we consider necessary. We shall obtain an understanding of the accounting system in order to assess the adequacy as a basis of the preparation of the financial statements and to establish whether proper records have been maintained. We shall expect to obtain such relevant and reliable evidence as we consider sufficient to enable us to draw reasonable conclusions therefrom. The nature and the extent of our tests will vary according to our assessment of the company's accounting systems, and where we wish to place reliance on it the system of internal control, and may cover any aspect of the business operations. We shall report to you any significant weaknesses in, or observations on, the company's systems which come to our notice and which we think should be brought to your attention. Our tests should not, however, be expected to identify all weaknesses in the company's systems.

- 1.5 As part of our normal audit procedures, we may request you to provide written confirmation of oral representations which we have received from you during the course of the audit.
- 1.6 In order to assist us with the examination of your financial statements, we shall request sight of all documents or statements, including the chairman's statement and directors' report, which are due to be issued with the financial statements. We are also entitled to attend all general meetings of the company and to receive notice of all such meetings
- 1.7 (Where appropriate) we appreciate that the present size of your business renders it uneconomical to create a system of internal control based on the segregation of duties for different functions within each area of business. In the running of your company we understand that the directors are closely involved with the control of the company's transactions. In planning and performing our audit work we shall take account of this supervision. Further, we may ask additionally for confirmation in writing that all the transactions undertaken by the company have been reflected and recorded in the accounting records, and our audit report on your company's financial statements may refer to this confirmation.
- 1.8 The responsibility for the prevention and detection of irregularities and fraud rests with you. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records resulting from irregularities or fraud, but our examination should be relied upon to disclose irregularities and fraud which may exist.
- 2.0 (Where appropriate) **Accounting and other services** – *Either include here or set out in a separate letter*

It was agreed that we should carry out the following services as your agents and on the basis that you will make full disclosure to us of all information.

We shall:

- 2.1 Prepare the financial statements based on accounting records maintained by you
- 2.2 Provide assistance to the company secretary by preparing and lodging returns with the registrar of companies.
- 2.3 investigate irregularities and fraud upon receiving specific instructions

3.0 (Where appropriate) **Taxation Services**

3.1 Our engagement as tax advisors requires us to prepare and lodge with the Income Tax department provisional and final income tax returns along with their supporting computations and documents and financial statements and to review and advise you on correspondences or notices received from the tax authorities.

3.2 We shall be pleased to advise you on matters relating to the company's tax liability, the implication of particular business transactions and on other taxation matters you refer to us.

4.0 **Fees**

4.1 Our fees are computed on the basis of the time spent on your affairs by the partners and our staff, and on the levels of skill and responsibility involved. Unless otherwise agreed, our fees will be charged separately for each of the main classes of work described above, will be billed at appropriate intervals during the year and will be due on presentation.

5.0 **Agreement of Terms**

5.1 Once it has been agreed, this letter will remain effective from one audit appointment to another, until it is replaced. We shall be grateful if you could confirm in writing your agreement to terms of this letter, let us know if they are not in accordance with your understanding of our terms of appointment.

Yours faithfully

Review Questions

Question One

- a. Explain Any Five purposes of an engagement letter
- b. What procedures should be followed in connection with engagement letters
- c. List down the contents of an engagement letter

Question Two

Kamau, a CPA finalist received a call from Ochieng who intends to start a business dealing fish export. Ochieng intends to appoint Kamau as his accountant. Kamau approaches you requesting for assistance

Required

Draft a simple engagement letter from Kamau to Ochieng

Question Three

Manu Producers Limited is a family company has been in operation for the last ten year. The company's auditor, John Kamau, has just relocated to South Sudan for greener pastures and he is not likely to come back soon.

Ruth Wanjiku, one of the directors of the company has approached you with a request that your firm accept appointment as auditors to the company. Further she has asked you or one of your partners to accept to be a director of the company. She has also requested whether one your member of staff would take upon the position of company secretary.

Required

- a. Steps to be taken to establish your firm's appointment as auditors
- b. The matters which you feel should be included in a suitable engagement letter
- c. Your proposed reply, giving your reasons, to the request that you or one of your partners should accept appointment as a director and that one of staff member should accept appointment as a company secretary.

Question Four

- a. State Four major matters you expect to find in a letter of engagement, showing clearly in each case the reasons for inclusion of the matter concerned
- b. Your firm intends to send another engagement letter to a client of long standing who has already had such a letter when engagement commenced. Give concise reasons for adopting such an approach
- c. Assuming that a new client requests you to assist him in writing up the accounting records and in preparing the financial statements, indicate what steps might be appropriate to ensure that you firm's role is properly exercised
- d. List down Six services other auditing commonly provided by firms of professional accountant.

Chapter Six – Accounting and Internal Control Systems

Introduction

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

Auditor's Interest in Accounting System

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

- The auditor should ascertain the enterprise's system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements
- The auditor has a duty, in preparing their report carry out investigations so as to enable them form an opinion.

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

Management's Interest in Accounting System

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

- The business operations are easy to control when proper books and records are maintained
- Day to day records of debtors and creditors are indispensable
- Assets and other resources are easily safeguarded
- It is easy to prepare reliable and accurate financial statements if and only proper books of accounts are maintenance
- It is a statutory requirements to maintain these accounting records and books

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

Importance of Accounting Control System

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

- To ensure that all transactions are recorded properly
- Errors and irregularities are avoided
- Assets and liabilities are recorded at their correct values

Internal Control System

Internal control may be defined as “the whole system of control, financial or otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient way, ensure adherence to the management policies, and safeguard the assets and secure as far as possible the completeness and accuracy of records”

Types of Internal Controls

The types of internal controls are categorized as follows:

a. Organisation

An enterprise should have a proper allocation of responsibility to key departments and functions. The enterprise should establish a good plan of organisation popularly known as organisation chart which should among other things identify lines of reporting. Employees should always know precisely to whom they report and who reports to them. The employees should their accountability and responsibility.

b. Segregation of Duties

Of maximum importance from an internal control standpoint is segregation of duties where no one single person should be given too much powers especially regarding recording, approval and custody of transactions. Several people should be involved in a single transaction to avoid fraud and collusions.

c. Physical

This concerns the physical custody and access to the company's assets and other resources. Access may be direct or indirect such as through documentation and other authorization. The access may be through other authorization such as through password and other restrictions.

d. Authorization and Approval

This is a special type of physical custody whereby the employee must be authorization through documentation to perform a specified task. For instance all credit sales must be approved and authorized before the transaction goes through.

e. Arithmetical and Accounting

This involves the physical checking of the arithmetical and accounting accuracy. It is important for instance to cross check balance before the close of the day.

f. Personnel

Procedures should be designed to ensure that personnel operating the system are competent and have the requisite skill to carry out the necessary operations. The personnel must be of high integrity and high training and expertise. The management should put in place the necessary measures to hire, fire, and train, promote and remunerate well the personnel in their employment.

g. Supervision

All the actions of an enterprise must be supervised by well qualified personnel. The responsibility and accountability of both the supervisor and the supervised must precisely stated and known to both.

h. Management

These are controls exercised by the management which are outside and over and above the day to day routine of the system. They include overall supervisory controls, review of the management accounts, variance analysis, internal audits and any other special review procedures.

Importance of Internal Controls

Internal control system is of paramount important in any business enterprise. The following are the reasons why the system is important:

Enables management to carry out the business in an orderly and efficiently

Internal controls lay down the various procedures to be followed in conducting business transactions.

Ensures adherence to management policies

The controls lay down the procedures to be followed in the conduct of business. In simple terms the management policies are explained through the internal controls

Safeguards the company assets

Internal controls are designed to ensure that the resources and assets of the company are protected from fraud, theft and embezzlement.

Ensures completeness of and accuracy of records

The companies' Act cap 486 requires that the business enterprise must keep proper books of accounts besides financial statements

Helps in preventing and detecting errors

Strong internal controls assist in preventing and detecting errors. It is the responsibility of the management to prevent and detect errors. This is achieved through continuous review of the books of accounts such as internal audits, variance analysis etc.

Helps in compliance of the necessary legislation and regulations

Internal controls assist in ensuring that the business complies with applicable regulations and legislations.

Review Questions

Question One

- a. Define internal control
- b. Explain importance internal control system
- c. Internal controls play a great role in business. Explain whose responsibility it is to put in place an internal control system
- d. List down the types of internal controls

Question Two

The internal control is defined in Auditing Standards and Guides as “the whole system of controls, financial and otherwise, established in order to:

- i. Carry on the business of the enterprise in an orderly and efficient manner
- ii. Ensure adherence to management policies
- iii. Safeguard the assets and
- iv. Secure as far as possible the completeness and accuracy of the records

Required

- a. In respect of management objectives (i) to (iv) above explain their meaning and relevance of each to the auditor giving an opinion on financial statements
- b. Assuming that in previous years you had recorded the system of internal control and had filed the relevant flow charts and system notes in the audit permanent file , describe briefly how you would approach the work of determining the systems in use during the current year's audit

Question Three

- a. Detail the auditors interest in the client's accounting records
- b. List down the reasons as to why the management should maintain good accounting systems
- c. Give reasons as to the importance of internal controls

Chapter Seven – Types of Audits

Introduction

Generally the audit to be undertaken depends on the reason as to why the auditing exercise is required. There are quite a number of types of audits. These are:

- i. Statutory Audits
- ii. Private Audits
- iii. Internal Audits
- iv. Management Audits
- v. Government Audits

Each of these types are explained here below

Statutory Audits

These are those audits that carried out as stipulate and governed by the prevailing laws of the land. These legislations include Companies' Act Cap 486, Building Societies' Act, and Provident Act and other legal provisions. There is a legal requirement for these audits failure to which the directors and other officers of the company are liable to an offence

Private Audits

A private audit is carried by an independent auditor at the request of the shareholders or other interested stakeholders. The cost incurred is borne by the shareholders or the stakeholders who requested the audit. This is not a legal requirement but a personal or group request. There varied reason why the group or a person is interested in this type of audit. Some of the reasons include:

- i. Before liquation
- ii. During mergers
- iii. During take – overs
- iv. During IPOs

Internal Audits

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It is an independent appraisal technique or activity used to review the operations of the business organisation.

It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organization's effectiveness and efficiency by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organizations to perform the internal auditing activity.

The scope of internal auditing within an organization is broad and may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations.

Internal auditing frequently involves measuring compliance with the entity's policies and procedures. However, internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds.

Internal is thus:

- a. Carried out by personnel – the internal auditor is appointed by the management and is expected to be independent in that he/she reports directly to the board of directors to the auditing committee of the board of directors.
- b. An appraisal activity – the work of internal auditors is to appraise the work done by the others within the organisation
- c. A service to the management – the management needs that the policies are fulfilled besides that the information used is both reliable and complete. The management requires also that the company's assets and resources are well safeguarded. It is sole responsibility of the internal auditor to make that the policies are adhered to, information is reliable and complete and that the assets and resources are safeguarded.
- d. Managerial control – the internal auditor is concerned that the internal control system is effective and efficient and working as required. There need to measure and evaluate the continuous effectiveness and efficiency of the internal control systems

Methods and Procedures of Internal Auditing

The internal auditor's approach to his/her work depends on how his/her role is defined in organizational chart but most of the internal audits are included in the following broad definitions

- **Operational Audits** – this means an audit of a specific set of operations such as the ones carried out on departments
- **Functional Audits** – this implies an audit of specific function within the such as the way the payroll is prepared
- **Organizational Audits** – this implies audits of the organizational setup.
- **Company Audits** – in the modern business, companies are in groups and the internal audit may be the concern to audit one of those companies within the group
- **Special or Ad hoc work** – an internal is often considered a suitable person to engage in special investigation or trouble shooting assignments

Reliance on Internal Audits

The external auditor may rely on the work of internal auditor while carrying his/her audit work. The internal and external auditor must co – operative due to the following reasons:

- Internal audit forms part of internal control system which has been established by the management. The external auditor has accustomed himself or herself to place reliance on the internal controls
- Some of the objectives of the internal audits are almost the same as for the external auditor

The external auditor may use the work of the internal auditor in two ways: one by taking into account the work done by the internal auditor and two by agreeing that the internal will render direct assistance to the external auditor.

Before placing any reliance on the work done by the internal auditor, external auditor must assess the internal auditor and his/her work regarding the following areas of concern:

- i. Independence of the internal auditor – the internal auditor is an employee of the company, but may be in a position to organize his or her activities in such a way that he or she reports

objectively and is not compromised at all. If this is possible then the external auditor can highly rely on the internal auditor's work otherwise do not rely on it

- ii. The scope and the objectives of internal audit – the external auditor should whether the scope of the work done by internal auditor is satisfactory and can be used for external audit
- iii. Due professional care – in order for the work of the internal auditor to be of any use it must have been done professional and in regard to all required standards and guidelines.
- iv. Technical competence – for the work of the internal auditor to be useful, the person conducting the internal audit must be technically qualified as per requirements of the companies' Act Cap 486 of laws of Kenya
- v. Recording standards – the external must assess whether the necessary reporting standards were applied when the internal audit reports were made
- vi. Resources available – an internal audit department that has scarce resources may not be relied at all and may not be useful to the external auditor's work

Extent of Reliance

The extent of reliance on the internal audit work depends upon many factors some of which include the following:

- Materiality
- Level of audit risk
- Judgment level required
- Sufficiency of complementary audit evidence
- Specialized skills of the internal auditor

In conclusion the scope and objectives of the internal auditing include the following:

- Reviewing the accounting systems and internal control systems
- Examining financial and operating information for the management
- Reviewing the economy, efficiency and effectiveness of operations and of the functioning of non financial controls
- Review and implementation of corporate policies, plans and procedures and
- Special investigations as may be needed from time to time

Management Audits

A management audit may be defined as an enquiry into the advisability of any of the policies of the board of directors in furthering the objectives of the business as defined in the memorandum and /or into the efficiency with which they are securing the execution of the policies

Some of the areas which might be subject of the management audit enquiry include:

- The objectives of the business: are these objectives right? Are the objectives being pursued and met?
- The relationship of the business with shareholder, investors and the financial markets
- The standing of the company with the public, customers, suppliers and other members of the public
- Relations with trade unions and the employees, labour turnover, health concerns and safety matters and issues, training policies etc
- Moral of employees
- Financial ratios both the trend and industrial
- Financial control
- Information flow – is the flow of information adequate or not

Review Questions

Question One

- a. List down and explain the types of audits
- b. Define the term internal auditing
- c. Explain the methods and procedures of internal auditing
- d. Compare and contrast the work of the internal and external auditors

Question Two

- a. Why might the external auditor rely on the work of the internal auditor?
- b. In what ways might the internal and external auditor co – operate?
- c. Explain the factors that influence the extent to which the external auditor will rely on the work of the internal auditor

Question Three

You are an auditor with You and Me partners for which you audit the accounts of Mimi Na Wewe limited. After the results of the financial year just ended you are invited for a meeting with the CEO of Mimi Na Wewe limited.

During the meeting which cordial, friendly and informative, the CEO suggested that the external auditor may well be necessary for the outsider user of financial statements in so far as he adds credibility to those statements but as far as management was concerned external audit was just a nuisance. He felt that internal audit was much more valuable and believed that the firm should be doing much more to co – ordinate you work with that of the internal auditor.

Required

- a. Explain what CEO meant by the statement that external auditor needs to add credibility to financial statements
- b. Show why the management may have come to the conclusion that internal audit is more useful to them than the external audit
- c. Explain to the CEO in what respect you believe the external audit may also be of considerable value to the management. Give examples
- d. State the reasons why the external auditor may use the work of the internal auditor

- e. State the extent to which you believe the internal auditor can benefit from co – operating with the external auditor

QuestionFour

- a. Define the term management auditing
- b. Distinguish between management auditing from internal and external auditing
- c. List down the matters that might be included in a management auditing

Chapter Eight – Stages of Modern Audit

Introduction

An audit can be carried out on the enterprises both large and small, and both new and well established. The audit of smaller enterprises has special features. This chapter describes the stages involved in the audit of an established which is big enough to have a comprehensive system of accounting and record keeping and a system of controls over those records

Outline of Stages

The stages that are involved in a modern audit consist of the following:

- Background research
- Audit plan preparation
- Review of the accounting system
- Review of internal control system
- Analytical review
- Preparation of the audit report

These stages are explained here under.

Background Research

The most important aspect is that before the start of the audit, the auditor must establish and discover as much as possible regarding the following:

- The present and the future trends and prospects regarding the industry into the client operates
- The past history and the present condition and future prospects and trends regarding the client
- The management and key personnel of his client and any recent changes
- The products and manufacturing and trading processes of the client and any recent changes
- The locations of all his client's operations

- Any difficulties encountered by the client in manufacturing, trading, expanding, contracting, labour relations or financing
- Any problems in accounting or in internal control systems
- Any problems in accounting measurement
- Any problems likely to lead to audit risk
- Any problems likely to be met in carrying out the audit
- Any changes in law or accounting practising which may affect the client

The background research is done through reading and interviewing:

- Previous years audit files
- Audit staff who have been previously engaged on the audit
- Published materials concerning the client company and the industry
- The company's interim, internal and management accounts
- The management of the enterprise

Audit Plan

The auditor must arrange to plan his audit in some details. The plan will involve preparation of a memorandum showing the following aspects:

- The staff members who will do the audit work
- The outline of the audit work to be done on each part of the client's system and financial statements
- The location of the audit work
- The timing of the work to be done
- A budget of the time
- A budget of cost

The audit plan must conform to the client's time requirements and the clients ability to produce necessary analyses and summaries

Review of Accounting System

The auditor must:

- Ascertain by asking questions
- Record on paper
- Corroborate his record and confirm that the record is correct
- Review for adequacy and of planning of tests.
- Test to determine that it always works as it is supposed to.
- Evaluate
- Form a conclusion on the adequacy of the clients system for documenting and recording the transactions, assets and liabilities of the client in the book of account and other records. This is because:
 - ✓ The companies Act requires that the auditor investigates and reports on the company are keeping of proper accounting records.
 - ✓ The books of account and other accounting records form the basis of the preparation of the financial statements

Review of Internal Control System

The auditor is required to:

- Ascertain
- Record
- Corroborate the record
- Review
- Test
- Evaluate and
- Form a conclusion on the adequacy of the client's internal control system

The internal control system consists of procedures that ensure that all the transactions, resources and liabilities are recorded correctly.

The main object of the review of both the internal control and accounting systems is have the evidence that the client among other things:

- Maintains adequate books of accounts and records

- Has a system in place of internal control over processing and recording of transactions to the extent that all transactions are recorded correctly both in principle and numerically
- The accounting records can adequately be relied upon to form a basis for preparing of financial statements.

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

Substantive Testing

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

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

- Where internal control system is weak and cannot be relied upon
- Unusual or extra – ordinary or one – off transactions
- All assets and liabilities at the balance sheet date

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

Analytical Review

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

- Proper books and records have been kept and form a reliable basis for preparation of financial statements

- The accounts have been properly drawn up the those books and records
- All assets, liabilities and transactions, balances and items in the accounts and records have been confirmed indirectly by systems investigations

After this the auditor is required to subject the financial statements to a thorough and overall analytical review to establish whether:

- Acceptable, consistent and appropriate accounting policies and Generally accepted accounting principle have been applied
- All the information contained in the financial statement is compatible and consistent with all other information
- All the items and information in the financial statements are compatible with the auditor's knowledge of the client's enterprise and its circumstances
- There is adequate disclosure of all items and information that need to be disclosed
- The accounting requirement of the Companies' Act Cap 486 and other regulations and legislations have been complied with
- The auditor has sufficient evidence to enable him give an opinion on the truth and fairness of the financial statements

Preparation of Report

The main objective of any audit is definitely the audit report to the client. The audit report is a formal statement showing the following:

- The name of the auditor who performed the audit work
- The name of the persons to whom the audit report is addressed such as the client's directors etc
- The financial statement being reported on such as income statements, statement of financial position and cash flow statements
- A statement showing the opinion of the auditor whether the statements give a true and fair view
- A statement showing the opinion on whether the statement comply with requirements of the Companies' Act Cap 486 and other regulations and legislations

Review Questions

Question One

- a. List down the stages of a modern audit
- b. What are background facts must the auditor discover?
- c. How are background facts determined
- d. What are the steps in an accounting system review?
- e. Define what is meant by substantive testing
- f. Outline the steps in the review of internal control system
- g. What are the objectives of an analytical review
- h. Outline the contents of an auditor's report

Question Two

- a. List the main features of an audit
- b. Describe briefly each of features of an audit

Question Three

Your daughter has written to you stating that she is contemplating to follow in your footsteps and study accountancy. However, she is finding it difficult to understand the nature and purpose of an audit and she has requested for assistance.

Write an appropriate letter, in a simple language describing what an audit is.

Chapter Nine – Audit Evidence

Introduction

The main objective of auditing is the verification of accounting data besides determining the accuracy and reliability of the accounting and financial statements and reports of any business enterprise. Verification does not exactly mean that there is certainty in connection with the data and financial statements being audited. It means seeking for sufficient evidence to satisfy oneself as the auditor that the statements and accounts show true and fair view. Sufficient evidence depends on the experience, knowledge and expertise of the auditor. The auditor is required to obtain evidential material to support the accounts and financial statements. The evidence available to the auditor varies in reliability, and the auditor must consistently be aware of this fact.

Types of Evidence

Various classifications of evidence are presented in this section together with relative reliability of each type of evidence and the factors that affect the reliability. These types are discussed here below

Primary Evidence

The source of the figures in the financial statements of any business enterprise is the general ledger. The general ledger receives its figures from the various types of journals and it is these books of account that form the primary source of evidence. The auditor has a primary role of ascertaining whether the financial statements and records agree with the primary source of data.

The auditor must ascertain that the figures in the journals originate from the source documents and they tally with the figures in the financial statements and accounts. He must ascertain the double entry rules have been followed to the letter.

Once the auditor is satisfied that the figures are in an agreement, then the next step is to look to the propriety, validity and accuracy of the ledger balances and the entries in the journals

Supporting Evidence

The amount of supporting evidence to be consulted by the auditor in corroboration with the books of accounts will be the inverse relation to internal control that entered into the preparation of these

records. The stronger the internal control the more reliable the supporting evidence and vice versa. There are two types of supporting evidence. These are:

Physical evidence

The physical evidence is somewhat limiting in that it can only be used in tangible assets. The examination of the asset is clear indication that the asset really exists.

Documentary Evidence

The type of evidence most commonly consulted by the auditor is documentary evidence. This is evidence that is found in documents and such sources. Documents vary widely in terms of their reliability as evidence. Documentary evidence can further be classified as follows:

- i. Externally created documents sent directly to the auditor – these documents prepared by third parties but sent directly to the auditors such as bank statements.
- ii. Externally created documents in the client's possession – these documents prepared by the third parties but the client has the possession of these documents such as sales orders
- iii. Evidence originating from within the client's organisation – the auditor is likely to gather evidence from within the client's organisation. This evidence may be verbal or written, formal or informal.
- iv. Internal evidence circulating outside business – information from the client but is the hands of external parties.
- v. Internal evidence circulating within the organisation – this is information circulating within the business only.

Circumstantial Evidence

This is that form of evidence is indirect evidence either presented knowingly and unknowingly. This form of evidence involves circumstances from which a reasonable inference can be drawn of the existence of a given fact or occurrence of a given event.

Techniques of Collecting Evidence

There are several methods of collect audit evidence. These methods are:

- Physical Examination and counting
- Confirmation from third parties either verbally or formally

- Examination of original documents
- Re – computation of figures
- Retracing book – keeping records
- Scanning
- Enquiry
- Correction
- Correlation
- Observation

Review Questions

Question One

- a. Define the term audit evidence
- b. Explain the main types of evidence that the auditor is likely to encounter
- c. Distinguish between primary and secondary evidence

Question Two

You have appointed the auditor of a furniture manufacturing company in your neighborhood

During your audit you collect different varieties of evidence in order to form your opinion on the truth and fairness of the financial statements. A selected list of some of the varieties of evidence is given under

- i. Witnessing of procedures
- ii. Testimony from independent third parties
- iii. Satisfactory internal control
- iv. Subsequent events
- v. Agreement with expectations

You are required to

- a. state under each variety of evidence four circumstances during the audit of the company where you would apply that variety and
- b. briefly indicate why you would require that piece of evidence in each circumstance

Chapter Ten – Auditor's Report

Introduction

The auditor's report is the final product of the audit work. It is usually very short but very important to the enterprise concerned. The auditors' reports should not by any chance be under – estimated. Most auditors' reports are short statement just expressing the opinion of the auditor the truth and fairness view of the accounts. The auditors' report is supposed to show whether the financial statements comply with the necessary accounting standards and the necessary legislation and regulations.

The matters to be expressed in the auditors are expressly stated in the Seventh Schedule of the companies Act Cap 486 and also in the auditing guidelines. The sixth schedule is reproduced below:

*SEVENTH SCHEDULE (s. 162)
Matters to be expressly Stated in Auditors' Report*

1. *Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit*
2. *Whether, 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 purposes of their audit have been received from branches not visited by them.*
3. (1) *Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.*
(2) *Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view –*
 - (a) *in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and*
 - (b) *in the case of the profit and loss account, of the profit or loss for its financial year,*
or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.
4. *In the case of a holding company submitting group accounts whether in their opinion, the group accounts 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 dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.

Essential Requirements

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

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

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

The auditing guidelines requires that the auditor must

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

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

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

- d. If the auditor has not received all the information and explanation which he deems necessary for the purpose of the audit

Note that these matters are only mentioned in the report only in the circumstances that they relate.

Content of the Auditors Reports

The Companies' Act Cap 486 and the Auditing Guideline give the auditor some specific duty regarding the content of the auditors' report. If certain information is not given in accounts and the financial statements, then this information need to be given in the report. Some of this information includes

- Particulars of directors' emoluments including pensions etc
- Particulars of loans to the officers of the business
- Particulars of emoluments which the directors waived the right to receive
- Particulars of contracts in which the directors have interest

As you may noticed the information is only touching on the directors.

The auditors' report has basically five sections as shown below

Section One – The Heading.

This section contains to whom the report is made. In starts with the words '*Auditors Report to*

Section Two – What the Auditors have done

This section contains the work the auditors have done and starts with the words "*we have audited the financial statement on page ... to page ...*

Section Three – The Opinion

This contains the opinion of the whether the books of accounts have maintained properly and whether the financial statements give a true and a fair view of the state of affairs of the business for the period under consideration. The section starts with the words "*in our opinion the financial statements have been prepared under historical cost convention and give a true and fair view of the company's state of affair for the year ended 31 December 2011*

Section Four – the name of the auditor

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

Section Five – Date the Auditors' Report was signed

This section has the date the report was duly signed

Types of Auditors' Reports

There are two types of audit reports. These are:

- i. Unqualified Reports – these are clean reports whereby the auditor was satisfied that all the necessary information and clarifications were properly made. All the issues that the auditor may have raised were properly addressed and all the supporting documents provided
- ii. Qualified Reports – these are reports whereby the auditor was not satisfied with the explanation clarification and other matters that he/she required from the officers

Review Questions

Question One

- a. Explain the contents of the auditor report
- b. Explain the types of audit reports

Question Two

Your cousin Jane Odhiambo is employed in a small branch of a bank where she is involved only with customers' personal accounts. You have received a letter from your cousin in which she informs that she about to be transferred to a larger branch where she will be involved with customers who are limited companies. Your cousin has requested you to write something about audits and audit reports

You are required to explain in the letter

- a. The nature and purpose of the audit of a limited company
- b. The meaning of the audit report and its content

Chapter Eleven– Auditing Computerized Systems

Introduction

We live in a fast-moving and automated world of information superhighway. No country or organization can afford to be left behind since by doing so, she risks underdevelopment, isolation and backwardness. Most businesses are no longer using the manual way of book – keeping technology of the late nineties but are now keeping records in soft copies and are using either tailor – made or general purpose software to keep their records. This calls for newer and sophisticated ways of auditing. Vouching and other methods of auditing are done through the computer software. This chapter draws its content from International Standards on Auditing numbers ISA 401 – Auditing in a computer Information System and ISA 1008 – Risk Assessment and Internal Controls

Features of Computerized Systems

There are fundamental differences between manual systems and computerized systems. The manual systems are likely to physical controls as opposed to the computerized systems whereby the controls may be both physical controls and system in – built. The fundamental differences are:

1. Computerized systems are complex as compared to manual systems. The auditor is likely to spend a few hours to understand a manual system but a computerized system may take a lot of time to understand besides requiring expert skill and technical know – how.
2. A separation between computer and user personnel that may be physical but is also likely to psychological and due to use of technical jargon and language in speech communication. The natural physical check for errors and fraud may not be in place.
3. There is lack of visible and physical evidence in computerized systems as opposed to manual systems. The information contained in soft records is not easily examined.
4. The data in soft copies may be stored for a short period of time as opposed to manual system where data can be stored for a long periods of time
5. Computerized systems can have automatic control to check as programmed. Manual systems lack this capability.
6. It is easy to access data and output in computerized systems as opposed to manual systems where data must be accessed manually.

7. Lack of audit trail in computerized systems as opposed to manual systems where one trace a transaction through the system from initialization up to the end
8. A single input in a computerized system update all the necessary file as opposed to manual system where the update must be done to each and every file

Internal Controls in a Computerized System

For all processing systems, including computerized systems, accuracy and reliability can be achievable only with conscious planning designed to assure satisfactory results. Information, protection, and control, the objective of internal control earlier, are equally applicable to computerized systems. In order to minimize the risks associated with special features in computerized the management is advised to design controls over computerized systems. These controls usually consist of both manual systems and in – built procedures. These controls are classified as; General controls and Application controls

General Controls

A company designs general controls to ensure that its overall computer system is stable and well managed. General controls relate to the environment within which computerized systems are developed, maintained and operated. These controls are aimed at providing reasonable assurance that overall objective of the internal controls are achieved. They at ensuring proper development and implementation of application are achieved and that the integrity of both data program is achieved. These are designed to make sure an organization's control environment is stable and well managed. They apply to all sizes and types of systems.

General controls are usually classified into four categories. These are:

- System development controls
- The plan of organisation and operation of the computer activity
- Access controls
- Back – up and recovery procedures

Systems Development Controls

These controls relate those controls that must be exercised by the client when designing new systems or modifying existing systems. The top management is required to participate in the systems

development for it to be effective. The controls that should be exercised during the systems development can be categorized into four:

Review, testing and approval of new systems

The basic principles of these controls

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

Controls over program

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

Parallel running of the new and old system

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

Documentation procedures

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

Plan of Organisation in Computer Activity

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

Segregation of Duties within Systems Function

- In highly integrated AIS, procedures that used to be performed by separate individuals are combined.
- Any person who has unrestricted access to the computer, its programs, and live data could have the opportunity to both perpetrate and conceal fraud.
- To combat this threat, organizations must implement compensating control procedures.
- Authority and responsibility must be clearly divided among the following functions:
 - ✓ Systems administration
 - ✓ Network management
 - ✓ Security management
 - ✓ Change management
 - ✓ Users
 - ✓ Systems analysis
 - ✓ Programming
 - ✓ Computer operations
 - ✓ Information system library
 - ✓ Data control
- It is important that different people perform these functions.
- Allowing a person to perform two or more of these functions exposes the company to the possibility of fraud.

Physical Access Controls

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

- ✓ Install locks on PCs.
- ✓ Restrict access of off-line programs, data and equipment
- ✓ Locate hardware and other critical system components away from hazardous materials.
- ✓ Install fire and smoke detectors and fire extinguishers that don not damage computer equipment

Logical Access Controls

- Users should be allowed access only to the data they are authorized to use and then only to perform specific authorized functions.
- What are some logical access controls?
 - ✓ passwords
 - ✓ physical possession identification
 - ✓ biometric identification
 - ✓ compatibility tests

Application Controls

Application controls prevent, detect and correct errors in transactions as they flow through the various stages of a specific data processing program. These controls ensure that the system produces results that complete and accurate. Companies must establish control procedures to ensure that all source documents are authorized, accurate, and complete and properly accounted for, and entered into the system or sent to their intended destination in a timely manner. Source data controls include:

- Forms design
- Pre-numbered forms sequence test
- Turnaround documents
- Cancellation and storage of documents
- Authorization and segregation of duties
- Visual scanning

- Check digit verification
- Key verification

Application controls are generally categorized into four groups. These are:

- a. Input controls
- b. Processing controls
- c. Output controls
- d. Control over master files and standing data

Input Controls

Faulty data input will always results into error and wrong output. Control over the completeness, validity, data conversion and controls of rejection of input are therefore very vital. Completeness control ensures that all transactions are recorded. Validity control ensures that only validly authorized transactions are the only ones transacted and recorded. Data conversion controls ensures that all data on source documents is properly entered into the system.

Processing Controls

These controls ensure that transactions are processed by the right software and program and transferred to the right master file besides producing the right output. Other input may be put in place such check overdue transactions and even credit limit.

Output Controls

These controls ensure that the right output is received from the input and that the results are accurate and that the out is distributed to appropriate personnel.

Control Over Master Files and Standing Data

These controls ensure that amendments to master file and standing file are complete accurate and properly authorized. These controls are similar to control over input.

Auditing In a Computer Environment

The use modern technology, especially computers in the processing of financial data and information has totally changed the general approach of the audit by auditors. The use modern

technology in processing the data and information does not in any way the responsibility of the auditor

Planning The Audit In A Computerized Environment

All audits must be planned. In a computerized environment must be taken in account and considered.

- i. The auditors need to be involved in computerized systems at the planning, development and implementation stages. Knowledge of the systems gained at these stages is vital and will enable the auditor plan his audit with an understanding of the system.
- ii. Timing is more important in a computerized environment than in manual systems. The auditor will need to be present when the data and files are available. More frequent visits to the client are usually required.
- iii. Recording methods in computerized systems and environment may be different. Recent developments include use of portable laptops and other methods data storage.
- iv. The allocation of suitably skilled staff and personnel to the audit is more vital. It may important and necessary to use computer audit department on some part of the audit.
- v. The extent to which computer assisted audit techniques (CAATs) can be used. These techniques often require considerable planning in advance.

Auditor's Approach in Computerized Environment

Due to the special features in computerized systems, it is necessary to devise appropriate audit approach. There are usually two main approaches that can be adopted. These approaches are:

- a. Auditing around the computer
- b. Auditing through the computer

Auditing Around the Computer

This approach assumes that the presence of accurate output verifies processing operations. The approach pays no attention to the control procedures within the information technology (IT) department. The auditor does not rely on controls be they manual or computerized. This approach is mainly substantive. This approach is only suitable where:

- The audit trail is complete and visible

- Processing is simple and
- Complete documentation of transaction is available

This approach has its own demerits such as:

- It is extremely risky to audit and give an opinion records that have been produced and processed by that one does not fully understand
- A computer has immense advantages for the auditor and it is inefficient to carry out an audit in this manner

Auditing Through the Computer

There are two basic techniques that are available to the auditors. These are:

- The use of test data and
- The use computer audit program

These methods are generally referred to Computer Assisted Audit Techniques (CAATs)

Computer Assisted Audited Techniques

CAATs refer to any automated audit techniques such computer software and test data. CAATs are ways in which the computer may be used by the auditor in a computerized environment to gather, or assist in gathering audit evidence. CAATs are mainly categorized into audit software and test data

Audit Software

Any software with that capability of directly reading and accessing data from databases is called *audit software*. The software has the ability to carry out mathematical computation and operations, statistical analysis, sequence checks etc. the software assists the auditor in accessing directly the data stored in computer's hard – disk and servers. There several types of audit software. These are

- i. Generalized Audit Software
- ii. Utility Programs
- iii. Purpose written Programs
- iv. Commercial Software
- v. Embedded Audit Modules
- vi. Integrated Test Facility

- vii. Parallel Simulation
- viii. Program Code Analysis

These are explained here under.

Generalized Audit Software

These come in diverse variety of forms. It may be software available over the shelf or tailor – made software to specification of the auditor. The software has the capability of perform a variety of functionalities such as reading computer files, selecting specific data, manipulating data, sorting data summarizing data, selecting samples, recalculations etc in a way specified by the auditor.

Utility Programs

These are program, which are generally not designed for audit purpose but can be used by the auditor to perform common data processing functions such as sorting, creating and printing files

Purpose written Programs

These are tailor – made programs specifically written either by auditor or programmers at the request of the auditor.

Commercial Software

These are off the shelf programs that are readily available in the market. These include the Microsoft Excel, Microsoft Word etc. these programs are used by the auditor in analysis as well as writing reports.

Embedded Audit Modules

This is CAAT in which a code is prepared by the auditor and embedded in the client's software. The code is designed to replicate a specific aspect of the control procedure or to record details of certain transaction in a file accessible only to the auditor

Integrated Test Facility

This is a facility forming part of the client's software and enables the auditor's test data to be integrated and be processed with the client's live input data. The facility ensures that the test data

updates auditor's dummy files. The dummy files are examined to ensure that the test data is properly processed as required

Parallel Simulation

The actual client's data is processed using a copy of the client's software that has undergone program code analysis by the auditor and under that control of the auditor. The two copies of processed data are compared to ensure that the processing is identical

Program Code Analysis

This is the analysis of the client's program code to ensure that the instructions given to the computer are the same instructions that the auditor had identified when reviewing the system development

Audit Software Use

By use audit software, the auditor is able to test huge volumes of data within a very short time. Besides these functions can be performed using audit software:

- ✓ File re – organization such as indexing, sorting, merging and linking with other files
- ✓ Data selection such as data filtration
- ✓ File access
- ✓ Arithmetic functions
- ✓ Summarizing data
- ✓ Sample selection
- ✓ Report printing

Test Data

In test data the auditor prepares the test data and the data is processed on the current production version of the client's software. The test data is processed separately from client's normal input data. The test data that is processed updates the auditor's copy of the client's data files. The updated files are examined to ensure that the transactions were processed in the right and the expected manner.

Review Questions

Question One

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

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

Question Two

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

Question Three

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

Required

- a. Explain the controls that can be established over completeness of input
- b. What controls can be established over validity
- c. Programmed edit checks are probably the most familiar input controls and certainly the most effective. Give examples of these controls bringing out clearly
 - i. The name of edit check
 - ii. Description of the control
 - iii. The objective of the control

Question Four

The directors of Wananchi Coffee Exporters Limited have resolved to introduce an improved computer based accounting system to replace the existing one. Live running of the new system is planned to commence on 1 February 2012 and will run parallel with the existing one system for a period of three months thereafter

Required

- a. Explain why the company should run both systems alongside each other prior to live running of the new system and give reasons why as the auditor would wish to be involved at this stage of the development process of the new system
- b. On the assumption that the new system will be ran as live from 1 February 2012, briefly describe what effect this have for the year ending 31 December 2012

