AUDITING AND ASSURANCE

REVISION KIT

Acknowledgment

We gratefully acknowledge permission to quote from the past examination papers of the following bodies: **Kenya Accountants and Secretaries National Examination Board (KASNEB); Chartered Institute of Management Accountants (CIMA); Chartered Association of Certified Accountants (ACCA).**

Contents

Part I: Introduction

This revision kit addresses needs of students preparing to sit CPA examination for Auditing.

The kit is divided into THREE main parts:

Part I: INTRODUCTION

- Approach to Examinations
- Syllabus
- Topical guide to CPA past paper questions

Part II: REVISION QUESTIONS AND ANSWERS

Past paper questions with model answers

Part III: Comprehensive MOCK examination papers with sample answers

To make effective use of this kit, candidates are advised to:

- Read widely some of the books suggested in the reading list so as to have adequate background information relating to the issues raised in the revision questions.
- Do the MOCK papers in part III under exam conditions and then check the solutions provided to assess their success in tackling the questions.

Given adequate and focussed preparation, this kit should be useful in enabling any student preparing for examinations in Auditing and related courses to pass with good grades in the exams.

Approach to Examinations

Experience in marking auditing examinations suggests that failure to answer all the questions and poor expression are every bit as frequent causes of failure as lack of knowledge. Lack of knowledge necessitates more learning, but the two other problems may not be so easily (!) solved. They are essentially inter-related, and while not exclusive to auditing they are perhaps more apparent in this subject. So the following ideas may help you to give your best performance ‗on the day'.

Remember that you gain most marks by citing the main concepts in response to a question. You gain little by going into immense detail. So it follows that you can score relatively the most marks in the first few minutes of your answer attempts – provided that you know the main concepts. And if you do not, then the examiner will not be impressed by a profusion of irrelevant detail. Indeed he may become annoyed, and this may cloud his view as to the rest of your paper. Examiners are only human (nearly!) remember.

To ensure that you have the opportunity of scoring on all the questions you must answer all of them! Even if you can produce four perfect answers five adequate ones will normally score better. And perfect auditing answers are very rare. So it is essential to divide your time up equally between the questions leaving a bit over for reading and review time. Be ruthless about the cut-off time. For if you creep over on your first few answers you risk having too little time for even the main concepts in your final answer.

Auditing answers require planning and a structure. Without this, expression will invariably be poor. And the introduction of unnecessary detail often makes matters worse. So concentrate on quality rather than quantity. And quality must apply to both your written English, which should be a professional style (it is after all a professional examination), and to your handwriting. Examiners try to decipher the indecipherable (usually), but the temptation to put a large cross through illegible work is very strong at the end of a long marking session.

Answer the question is an obvious point, which applies to any examination. But it is amazing how many candidates do not. So you must read the question carefully – perhaps once quickly through the complete paper to gather the main topics from each question, and then again in more detail to ensure that you have a proper understanding before you commence your answers. Then give your answer in the form that is required. For example, if a letter is asked for, give your answer in letter format. You will lose marks for an essay.

Examiners regretfully do not always supply perfect questions so if you find one that is ambiguous, choose another one if possible; but if not possible then state your assumptions and proceed logically from there. Even if the examiner disagrees with your assumptions, he should award marks for a logical, practical exposure. But he may not, just as he may not award marks if you are highly critical (of his opinions) in a question involving a controversial issue. So I would avoid such questions also, but if you cannot avoid them, ensure that you put both sides of the debate, and do not state your opinions in too forceful a manner. Where you are expressing your own opinion (to which you are perfectly entitled), ensure that this is distinguished in your answer from where you cite the opinions of others, or rely on recognized publications.

The auditing syllabus is large. And becomes larger with each new Auditing Standard and Accounting Statement. Questions are now being written much more imaginatively than in the past, and often test several aspects of the syllabus in just one question. An analysis of past papers will reveal certain aspects of the syllabus which examiners (rightly) concentrate upon (for example, stock, debtors and computers). While it is highly dangerous to ‗question spot' to the extent that your preparation for the examination involves only five topics, it is common senses to pay particular attention to those topics that are frequently examined.

Good luck!

Syllabus

AUDITING AND ASSURANCE

OBJECTIVE

To equip the candidate with knowledge on the nature and concept of auditing and its application to public and private organisations.

6.0 SPECIFIC OBJECTIVES

A candidate who passes this subject should be able to:

- Understand the environment under which auditing is carried out
- Understand the laws governing audit practice
- Perform the audit planning and design control processes
- Prepare various audit reports
- Understand the impact of information technology on auditing.

CONTENT

6.1 The General Audit Environment

- Definition of auditing
- Distinction between auditing and accounting
- Objects of an audit
- Types of audits
- Users of audited reports
- Internal versus external audits
- Stages of an audit
- Overview of the audit process
- Background information about the client
- Audit planning, controlling, recording and evaluating

6.2 The Legal and Professional Requirement for an Auditor

- Appointment
- Letter of engagement
- Qualifications of auditors
- Rights of auditors
- Dismissal of auditors
- Duties of auditors
- Legal liability of auditors
- Negligence and the auditor

- Professional ethics
- Auditing standards and guidelines

6.3 Internal Control Systems

- Definition of internal control, internal check and internal audit
- Types of internal control
- Qualities of good system of internal control
- Limitation of internal control
- Ascertainment and recording the system of internal control; internal control questionnaires, flow-charts, systems notes
- Evaluation of the system of internal controls: techniques of evaluation
- Compliance testing
- Internal controls and small businesses

6.4 Audit Evidence

- Nature of audit evidence and sources
- Methods of gathering audit evidence
- Qualities of good audit evidence; relevance, reliability and sufficiency
- Sampling in audit; reasons for sampling, methods of sampling, factors to be considered in sampling
- Qualities of a good sample

6.5 Substantive Tests and Audit of Profit and Loss Account and Balance Sheet

- Definition
- Techniques
- Audit programmes
- Tests of detail and analytical review
- Directional testing
- Techniques of analytical review of the profit and loss account
- Audit of revenues; purchases, and salaries and wages
- Audit of cash, accounts receivable, stocks including work-in-progress, and fixed assets
- Audit of liabilities and owners equity

6.6 Errors, Fraud and Other Irregularities

- Types of errors
- Fraud and defalcations
- Other irregularities
- Detection, correction and prevention
- Role of the auditor in respect to detection and prevention of errors and fraud
- Auditor‘s duty in event of errors, fraud and other irregularities detected in the audit process

6.7 Auditor"s Report

- Contents
- Types; unqualified, disclaimer and adverse reports
- Conditions requiring a report other than the standard unqualified report

6.8 Auditing in a Computerised Environment

- Impact of computers on the auditor
- Internal controls in a computerised environment
- Approaches to audit of computerised systems; auditing through the computer or round the computer.

Part II: Revision Questions and Answers

QUESTIONS - PAST PAPERS

CPA

AUDITING

July 2008 Pilot Paper **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

Audit planning process allows the audit senior to acquire adequate knowledge about the entity. This process ensure an effective control of audit work.

Required:

a) Explain the auditor's planning process when planning for an audit of a new client. (8 marks)

b) How does audit planning assist in the conduct of an audit? (5 marks)

c) Explain the following controlling procedures in a well planned audit:
   i. Direction and supervision of work. (2 marks)
   ii. Review and co-ordinating of work. (2 marks)
   iii. Quality controls. (3 marks)

(Total: 20 marks)

QUESTION TWO

Explain how you would verify the following:

a) Investment income. (5 marks)
b) Bank balances. (5 marks)
c) Contingent liabilities. (5 marks)
d) Petty cash balances. (5 marks)

(Total: 20 marks)

QUESTION THREE

a) Do you believe that the auditors should be responsible to users other than the shareholders? Give reasons to support your answer. (5 marks)

b) Does the auditor require a codified definition of ―reasonable care and skill‖ or should this be left to professional judgment? Explain. (5 marks)

c) Why should the auditor be unwilling to take full responsibility for the detection of fraud during the annual audit? Explain. (5 marks)

d) Discuss the proposition that the ‗expectations gap' has arisen because of the public's ignorance and should therefore be resolved by the public themselves. (5 marks)

(Total: 20 marks)

QUESTION FOUR

Explain the following terms:

(a) Materiality; (4 marks)
(b) The duty of confidentiality; (5 marks)

(c) Professional indemnity insurance; (3 marks)
(d) Peer review; (3 marks)
(e) Quality Control. (5 marks)

(Total: 20 marks)
(December 1997 Q.6)

QUESTION FIVE

You are an audit senior in a firm of practicing accountants and your manager has gone out for an urgent meeting with a partner. Mr. Charo, a manager with Charo and Company, a wholesale business has come to your office with a request that your firm becomes their auditors.

Required:

a) Describe to Mr. Charo the legal, ethical and practical factors your firm would consider before accepting the appointment. (10 marks)
b) Explain to Mr. Charo the qualification and disqualification of an accounting firm under the provisions of the Companies Act to become auditors. (10 marks)

(Total: 20 marks)

QUESTION SIX

The cashier of a firm who also acts a bookkeeper has been suspected of dishonesty. The books have not been audited for the last nine months.

You have been asked to investigate the records to establish whether the cashier has committed a fraud.

Required:

Outline how you would proceed with the investigation. **(Total: 20 marks)**

QUESTION SEVEN

It has often been said that the auditors' report is the formal result of all his efforts. This being the case, it is very important that the reader well understands the meaning of the Audit Report, particularly where the auditor wishes to qualify his opinion on the financial statements.

Required:

a) Under statutory provision, what are the main contents of the auditors' report?(6 marks)
b) Explain how the international standards on auditing attempt to ensure that the report of the auditors is clearly understood. (8 marks)
c) Describe clearly the circumstances in which an adverse opinion and a disclaimer of opinion would be appropriate and give two examples, one each, to illustrate your answer. (A full audit opinion is not required). (6 marks)

(Total: 20 marks)

QUESTION EIGHT

Printa Limited is a large printing company, which has an on-line computer accounting system. The system is based around a central main frame computer, with terminals serving individual departments. As part of the interim audit work, you have been asked to carry out a preliminary evaluation of ;

- The integrity of the data base as far as it is relevant to your audit and,
- The effectiveness of the computer controls over sales and debtors.

Required:

a) Describe the controls, which you would expect to be in operation in order to maintain integrity of the database. (10 marks)

b) Set out the points, which you would raise, in your preliminary evaluation of controls over sales and debtors. (10 marks)

(Total: 20 marks)

December 2008. **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

Working papers provide the audit evidence. They can be categorized into:

i. Auditors' prepared working papers.
ii. Client's schedules used as working papers.
iii. Audit programmes.

Working papers are then organized into files usually referred to as either current files of permanent files.

Required:

a) What details should each working paper which is prepared by an auditor indicate? (5 marks)
b) What details should each client schedule used as a working paper indicate? (4 marks)
c) What details should an audit programme indicate? (5 marks)
d) With appropriate illustrations, differentiate the use and contents of a permanent file from a current file and write brief notes on the evidence that is provided by working papers. (6 marks)

(Total: 20 marks)

QUESTION TWO

The matter listed below are always included in the internal control of a firm.

You are required to explain the purpose of each of the items listed as (a), (b) and (c) below. Indicate the compliance tests you would carry out in order to ensure that the intended controls were operating properly.

a) A requirement that mail is opened by two responsible employees who must promptly make listings of all receipts. (7 marks)
b) A rule that a fixed asset register must be maintained and updated promptly. (6 marks)
c) A requirement that a bank reconciliation statement is prepared on monthly basis.

(7 marks)
(Total: 20 marks)

QUESTION THREE

a) Write brief notes on the following auditing techniques:
   i. Inspection; (4 marks)
   ii. Observation; (3 marks)
   iii. Enquiry. (3 marks)

b)
   i. Define the term audit programme. (2 marks)
   ii. Write in point form an audit programme to cover salary and wages of a small size firm. (8 marks)

(Total: 20 marks)

QUESTION FOUR

During the course of an audit, the auditor attempts to obtain sufficient relevant and reliable evidence to provide the satisfaction that the financial records are completed and accurate. One of the ways that the auditor obtains satisfaction is to select representative samples of transactions and balances for detailed testing, such samples being made using either statistical of non-statistical methods.

Required:

a) Describe the main factors which influence the auditor in determining the size of the sample he will use for his detailed testing. (12 marks)

b) Describe three areas where the judgment will be exercised by the auditor when using statistical sampling. (8 marks)

(Total: 20 marks)

QUESTION FIVE

Your firm audits Clean Paints Ltd. and you are planning the audit of stock and work in progress for the year ended 31 December 2000. Clean Paints Ltd. determines the value of stock in its financial statements by the year -end stocktake. There is no perpetual Stock Inventory System though stock is counted quarterly for the purposes of management accounting.

Stock and work in progress is held at the warehouse which is next to the company's factory.

Required:

a) State the areas that you will expect the client's stocktaking instructions to cover. (12 marks)

b) Describe the work you will perform and the matters you will record at the stocktake attendance. (8 marks)

(Total: 20 marks)

QUESTION SIX

—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 conversions, controls 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. (6 marks)

b) What controls can be established over validity? (6 marks)

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 the edit control. (2 marks)

ii. Description of the control. (3 marks)

iii. The objective of the control. (3 marks)

(Total: 20 marks)

QUESTION SEVEN

Specialists or experts are occasionally required by external auditors mainly in connection with the valuation assets and the determination of liabilities.

Required:

a) The necessity for reliance on specialist. (12 marks)

b) The extent to which the specialist should be independent? (5 marks)

c) Competence of the specialist. (3 marks)

(Total: 20 marks)

QUESTION EIGHT

The auditing standard on subsequent events provide the basic principles and procedures as to the auditor‘s responsibilities and deal with:

i. Dating the auditor‘s report
ii. Audit procedures
iii. Events after the date of the audit report.

Required:

a) In the context of subsequent events, what is the significance of the data of the auditor‘s report? (3 marks)
b) Outline the audit procedures considered necessary between the balance sheet date and the date of the auditor‘s report. (8 marks)
c) Summarise the appropriate actions of the auditor regarding events after the date of the audit report. (9 marks)

(Total: 20 marks)

May 2009. **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

a) Give four merits of using a flowchart to record an accounting system. (4 marks)
b) Explain how an Internal Control Evaluation Questionnaire (ICEQ) differs from an Internal Control Questionnaire (ICQ). (4 marks)
c) List six examples of key control questions that would be suitable for inclusion in an ICEQ for a wages accounting system. (6 marks)
d) Explain the meaning of the following audit terms:
   i. Tests of control. (3 marks)
   ii. Substantive tests. (3 marks)

(4 marks)
(Total: 20 marks)

QUESTION TWO

a) Explain the meaning of the ‗audit evidence'.
b) Write a brief explanatory notes on the following terms in relation to audit evidence:
   i. Relevance. (2 marks)
   ii. Reliability. (2 marks)
   iii. Sufficiency. (2 marks)
c) Describe the various procedures of obtaining audit evidence giving an example of each by way of illustration. (10 marks)
(Total: 20 marks)

QUESTION THREE

The director of one of your growing clients have decided to create an internal audit function in their organizational structure.

Required:
a) List and briefly describe the duties you would expect the internal audit staff to perform. (10 marks)
b) List and explain the criteria which you would consider before deciding to rely on the work of the internal audit function. (5 marks)
c) State the extent to which you, as an external auditor, can rely on the work of the internal audit function. (5 marks)
(Total: 20 marks)

QUESTION FOUR

a) Write briefly explanatory notes on the following types of audit:
   i. Statutory audit; (2 marks)
   ii. Private audit; (2 marks)
   iii. Balance sheet audit; (2 marks)
   iv. Management audit; (2 marks)
b) Explain the value derived from the work of external auditors. (5 marks)
c) Outline the statutory provisions with regard to duties of external auditors. (7 marks)
(Total: 20 marks)

QUESTION FIVE

Write brief explanatory notes on the following audit terms:
a) Control procedures; (4 marks)
b) Internal check; (4 marks)
c) Vouching audit; (4 marks)

d) Walk-through tests; (4 marks)
e) Weakness tests; (4 marks)

(Total: 20 marks)

QUESTION SIX

You have been asked by your firm to examine the payment vouchers of a company to establish the level of errors and then decide whether better results can be obtained through statistical techniques.

Required:

a) State the steps you would take in order to test the vouchers for the errors. (12 marks)
b) Why is it not satisfactory to pick vouchers from a limited period? (4 marks)
c) State under what circumstances statistical sampling is a good technique. (4 marks)

(Total: 20 marks)

QUESTION SEVEN

a) In the context of a computer based accounting system, explain the meaning of the following terms:

i) Application controls (4 marks)
ii) General controls (4 marks)

b) State six examples of controls to prevent unauthorised changes to data files that you would expect to find in a new computer based accounting system (6 marks)

c) A company wishes to change from an old computerised system to a new computer based accounting system. Explain how and why both systems should run parallel prior to the change over the new system (6 marks)

(Total: 20 marks)

QUESTION EIGHT

You have been appointed the auditor of United Millers Company Limited, a medium manufacturing company which is quoted on the stock exchange.

Required:

a) List the important matters which must be included in the letter of engagement. (14 marks)

b) Explain the purpose of such a letter. (6 marks)

(Total: 20 marks)

December 2009. **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

You have received a request form XYZ Ltd. to accept an appointment as their auditor for the financial year ending 31 December 2001.

Required:

a) Explain the preliminary procedures you would carry out upon your appointment. (6 marks)
b) What is the importance of a preliminary review? (4 marks)
c) Why is it important for the auditor to hold discussions with the client's senior staff? (6 marks)
d) State why it is important for an incoming auditor to hold consultations with the outgoing auditor. (4 marks)

(Total: 20 marks)

QUESTION TWO

a) Why is an external audit necessary for companies registered under the Companies Act? (3 marks)
b) Under what circumstances is one ineligible for appointment as an auditor of a company? (4 marks)
c) Explain the procedure a company has to follow when changing its auditors. In your discussion explain _dismissal' and _appointment' of auditors by a company? (8 marks)
d) List the rights and duties of an independent auditor. (5 marks)

(Total: 20 marks)

QUESTION THREE

a) What are the main objectives of an internal control system? (5 marks)
b) What are the disadvantages of rigidly adhering to a system of internal control? (5 marks)
c) Explain the matters that have to be considered in respect of a system of internal control for cash sales in a service station that sells petrol and repairs motor vehicles. (10 marks)

(Total: 20 marks)

QUESTION FOUR

In the course of the audit of ABC Stationers Ltd. for the year ended 30 June 2001, you have noted and recorded in the audit working papers, the following evidential matters:

1. Flowcharts of the company's payroll prepared by your audit assistant backed up by tests of controls.
2. An oral statement by the production director that the expected working life of plant acquired during the year is ten years.
3. A letter to the managing director from the company's bank manager indicating that the bank intends to extend overdraft facilities for a period of one year.
4. A list of items of inventory counted by a member of your audit team during observation of the company's annual stock count.
5. A letter from a customer to your firm in reply to a confirmation request indicating agreement with the balance recorded in the books of ABC Stationers Ltd.

Required:

a) With respect to each matter listed above, explain its relevance to the overall audit objective of forming an opinion and reporting on the financial statements. (10 marks)
b) Explain your judgment on the reliability of the audit evidence obtained in five ways listed above. (10 marks)

(Total: 20 marks)

QUESTION FIVE

a) Define and explain the meaning of an audit programme. (4 marks)
b) List three disadvantages of using standardized audit programmes and how these disadvantages can be avoided. (6 marks)
c) Draft an online audit programme for the fixed assets of a large manufacturing company. (10 marks)

(Total: 20 marks)

QUESTION SIX

You have been the auditor of Crossborder Trading Company Ltd. for a number of years. The company's head office is in Nairobi, Kenya and if has considerable overseas operations. At each accounting year end, there are large debts due from overseas agents of the company (Sh. 270 million out of total debts of Sh. 680 million as at 31 December 2000). In the past, these debts have always been settled after year end but you have insisted that the debts be the subject of a specific representation made by the company's director.

Required:
a) Outline the purpose of a letter of representation from management to the auditor. (5 marks)
b) Draft a paragraph for a letter of representation appropriate to the circumstances described above. (3 marks)
c) Outline the audit work which should be performed when seeking evidence to substantiate the management's representations as drafted and indicated the value of the directors' representations in these circumstances. You should present your answer under the following headings:
- Existence and title. (3 marks)
- Valuation. (2 marks)
- Disclosure. (2 marks)

d) State what action you would take if the directors refused to provide you with a letter of representation. (5 marks)

(Total: 20 marks)

QUESTION SEVEN

a) (i) Describe the circumstance under which an auditor may be liable for damages for materials misstatements in published accounts on which he has expressed an audit opinion. (4 marks)
(ii) Under what circumstances can be avoid liability? (4 marks)
b) Identify the categories of parties who may institute successful legal claims against an auditor emphasizing the basis a court of law would use to assess the value of damages. (7 marks)
c) What specific actions can an individual auditor or audit firm take to minimize liability arising from audit risk? (5 marks)

(Total: 20 marks)

QUESTION EIGHT

Your client, ABC Ltd. has a system for inputting purchase and expense invoice where the operator inputs the following from each item.

Order number (a code 2221 is used for items like electricity)
Supplier name
Supplier code number

First four letters of nominal account name (entered on invoice by purchase department manager)

Nominal account code (entered by purchase department manager) Date

Goods inward note number Net amount

VAT amount
Gross amount

Required:

a) Suggest manual operation and controls which might previously have applied to these invoices. (6 marks)
b) Suggest input controls that might be applied by the program to these items. (8 marks)
c) List some audit tests that could be applied to these items indicating the purpose of each test and the relevant audit evidence obtained. (6 marks)

(Total: 20 marks)

May 2010. **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

a) Identify the potential users of audited financial statements. (7 marks)
b) What are the specific needs of the potential users of audited financial statements you have identified in (a) above? (7 marks)
c) An auditor is required to state whether, in his opinion proper books of account have been kept and whether the financial statements give a true and fair view of the state of the financial affairs of the company being audited.

What are the consequences, to the auditor, for giving an unqualified opinion, when he knows that there are material inaccuracies in financial statements? (6 marks)

(Total: 20 marks)

QUESTION TWO

One of the responsibilities of the directors of a company is to establish strong internal controls to safeguard the assets of the firm.

Required:
a) State the audit objectives of internal controls on fixed assets. (6 marks)
b) Set out the audit procedures you would follow to verify directors' fees. (7 marks)
c) What procedures would you apply to verify the extension of a building that has been constructed by the client during the year? (7 marks)

(Total: 20 marks)

QUESTION THREE

Many auditors now use laptops 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 auditors can use laptop computers in their audit work (other than computer-assisted audit techniques). (6 marks)
b) Explain the computer assisted audit techniques listed below:
   i. Embedded audit facilities. (2 marks)
   ii. Integrated test facilities. (2 marks)
c) Briefly describe two types of software that might be used by auditors in their work other than Computer Assisted Audit techniques. (4 marks)
d) Describe the controls that auditors should implement when using laptop computers on audits. (6 marks)

(Total: 20 marks)

QUESTION FOUR

a) List and briefly explain the general forms of qualifications available to the auditor in drafting his audit report, stating the circumstances in which each qualification is appropriate. Give an example of each circumstance. (8 marks)
b) List the principal matters, which the auditors considers in forming an opinion on the financial statements. (4 marks)
c) Outline the basic elements of an unqualified audit report. (8 marks)

(Total: 20 marks)

QUESTION FIVE

The auditor's operational standard states, —The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions thereon‖.

Required:

a) What factors would influence the judgment of the auditor with regard to sufficiency of audit evidence? (10 marks)

b) What factors would influence the auditor to accept third party certificates as audit evidence? (7 marks)

c) State the important factors that must be considered when assessing the reliability of audit evidence. (3 marks)

(Total: 20 marks)

QUESTION SIX

Control procedures consist of practices and procedures in addition to the control environment, established to achieve certain specific objectives. For each of the procedures listed below, explain the purpose of the control procedures and state the tests of control you would perform to confirm that the control objective was being achieved.

a) The preparation of a reconciliation statement. (4 marks)

b) The maintenance of a fixed assets register. (9 marks)

c) The existence of passwords in a micro-computer accounting system. (7 marks)

(Total: 20 marks)

QUESTION SEVEN

a) Give a definition of an —internal control system‖. (4 marks)

b) Describe the internal control procedures you would recommend to the owner of a medium size wholesale business to facilitate prevention and detection of errors and frauds. (16 marks)

(Total: 20 marks)

QUESTION EIGHT

Inspection and monitoring of quality control by a firm of auditors involves both in-house and external procedures. The internal procedures include the post-audit review, sometimes known as a —cold review‖. The external procedures are sometimes known as —external practice inspections‖ or —peer reviews‖.

Required:

a) Write explanatory notes on the —cold-review‖. (10 marks)

b) Explain the advantages and disadvantages of the —peer review‖. (10 marks)

(Total: 20 marks)

December 2010. **Time allowed: 3 hours**
Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

The National Metal Works Limited manufactures and retails door and window frames. The company recently dismissed their external auditors. The directors have approached your firm of accountants to act as their auditors and the directors have proposed a fee of KShs. 1, 000, 000 plus a bonus of 1% of profits after tax.

Required:

a) Describe the steps you would take before advising the partners of your firm whether to accept the appointment as auditors or not. (8 marks)

b) State with reason whether professional auditors should accept the method of remuneration as proposed by the directors of the client company. (6 marks)

c) Explain the implications of fixing the audit fee by negotiation between the directors and the external auditors on the independence of the auditor. (6 marks)

(Total: 20 marks)

QUESTION TWO

a) Briefly explain the meaning of the following terms as used in auditing:
   i. The materiality concept. (3 marks)
   ii. The going concern concept. (3 marks)

b) Explain five factors which would indicate to the auditor that the going concern assumption of the business entity he is auditing is threatened. (10 marks)

c) What is the form of audit opinion you would give if you concluded that the client company was experiencing going concern problems and:
   i. you have established that the financial statements give sufficient disclosure of the going concern problems? (2 marks)
   ii. you have established that there is no disclosure of the going concern problems in the financial statements? (2 marks)

(Total: 20 marks)

QUESTION THREE

You are the auditor of Bei Nafuu Supermarkets Limited across the country. The management has informed you that they intend to set up an internal audit function.

Required:

a) Identify and explain the function to be performed by the internal audit department in Bei Nafuu Supermarkets Limited. (8 marks)

b) List four factors that you would consider before placing reliance on the work of the auditors of Bei Nafuu Supermarkets Limited. (4 marks)

c) Explain four controls that you would expect to find in Bei Nafuu Supermarkets Limited. (4 marks)

d) Explain how the quality of the internal audit department of Bei Nafuu Supermarkets Limited can be assessed. (4 marks)

(Total: 20 marks)

QUESTION FOUR

b) You are a senior member of the audit team at Grain Millers Ltd., a company whose business is milling maize, wheat and other products for local consumption. The annual turnover for the year ended 30 September 2002 amounted to Sh. 1.5 million and most of its sales were on credit.

The audit team leader has assigned you the audit of the provision for bad and doubtful debts which has been set at Sh. 4.75 million; out of which Kshs 3.25 million relates to the provision against specific bad and doubtful debts and the balance of Sh. 1.5 million is a general provision determined as a percentage of overdue debtors with a higher percentage being applied against the longest overdue accounts.

Required:

i. Outline the audit procedure you would apply in verifying the general provision for bad and doubtful debts. (10 marks)

ii. Explain how you would verify the specific provision for bad and doubtful debts. (3 marks)

b) What is meant by the following terms as used in auditing:

i. Cut off procedure? (3 marks)

ii. Audit in depth? (4 marks)

(Total: 20 marks)

QUESTION FIVE

A very important aspect of the audit of the financial statements by an external auditor is the observation of the physical stocktaking.

Required:

a) Why does the auditor need to attend a stock-take of the company that he audits? (6 marks)

b) List four procedures that an auditor would need to undertake prior to attending a company‘s stock-take. (4 marks)

c) Explain the audit tests that the auditor would apply to establish the physical qualities of stock and their ownership. (4 marks)

d) How does the auditor satisfy himself that the procedure adopted by the management with regard to stocks have been applied throughout the financial period? (6 marks)

(Total: 20 marks)

QUESTION SIX

State the evidence, which you, as the auditor, would like to find in place and pay attention to when vouching the following payments made by RR Paper Mills Ltd., during the financial year ended 31 October 2002.

a) Loans to three employees totaling Sh. 6 million. (4 marks)

b) The last call on 5, 000 ordinary shares at Sh, 15 per share. (4 marks)

c) Fire insurance premiums amounting to Sh. 10, 000 paid for the office block. (4 marks)

d) A loan amounting to Sh. 30 million obtained from a local bank and secured by the factory building. (4 marks)

e) Salesmen‘s commissions amounting to Sh. 3, 000, 000. (4 marks)

(Total: 20 marks)

QUESTION SEVEN

a) State the basic element of the scope paragraph of an audit report. (4 marks)
b) Explain how auditors distinguish their responsibility from those of the directors in respect of financial statements. (4 marks)
c) Explain the meaning of each of the following terms in relation to audit reports:
   i. Circumstances of uncertainty. (4 marks)
   ii. Circumstances of disagreement. (4 marks)
d) Distinguish between the ―except for‖ and the ―subject to‖ audit opinions. (4 marks)

(Total: 20 marks)

QUESTION EIGHT

Your firm of accountants has been the auditors of Leather Merchants Limited, a company that exports both raw and semi-finished leather products to European and Asian markets. The company has decided to introduce a comprehensive computer system to manage its accounting and administrative functions.

Required:
a) Outline the practical difficulties you would encounter as an auditor as a result of the proposed introduction of a computerized accounting system. (10 marks)
b) Explain how you would overcome the difficulties identified in (a) above. (5 marks)
c) Identify and explain the benefits that the company would derive as a result of putting in place a comprehensive computerized accounting system. (5 marks)

(Total: 20 marks)

5 June 2011. **Time allowed: 3 hours**

Answer any FIVE questions. All questions carry equal marks.

Answer any FIVE questions

QUESTION ONE

(a) (i) Briefly explain the meaning of the term ―audit‖ (2 marks)
(ii) What are the objectives of an audit according to the Companies Act? (3 marks)
(b) List four advantages to a company of having its accounts audited (4 marks)
(c) Identify and list the responsibilities of company directors in relation to the company‘s accounting system. (6 marks)
(d) List five limitations of an audit (5 marks)

(Total: 20 marks)

QUESTION TWO

The internal control system encompasses all the policies and procedures adopted by the management of an entity to assist it in achieving management objectives.

Required:

a) Identify and explain five management objectives that an internal control system over sales aims to achieve (10 marks)
b) List and briefly explain five control objectives that an internal control system over sales aims to achieve (5 marks)
c) Explain are the inherent limitations of an internal control system (5 marks)

(Total: 20 marks)

QUESTION THREE

a) Distinguish between a procedural audit and a balance sheet audit. (8 marks)
b) Explain the nature and purpose of a post-audit review (4 marks)

c) Identify the audit procedures which would need to be carried out in order to identify material post – balance sheet events. (8 marks)

(Total: 20 marks)

QUESTION FOUR

You have completed your audit of Tinga Tinga Ltd. You have issued a management letter to the Chief Accountant which identifies weaknesses in the controls over sales. Cash is received over the counter, from salesmen and also through the post. Tinga Tinga Ltd‘s Chief Accountant has asked you for recommendations as to the type of controls you would wish to see in operation in a sales system.

Required:
Outline the controls you would expect to find in Tinga Tinga Ltd‘s sales system with regardto:

a) Cash receipts by post (5 marks)
b) Cash collected by salesman (5 marks)
c) Cash sales within Tinga Tinga Ltd‘s premises (5 marks)
d) Banking of cash received (5 marks)

(Total: 20 marks)

QUESTION FIVE

Audit working papers should always be sufficiently complete and detailed to enable an auditor with no previous connection with the audit to subsequently ascertain from them what work was performed and to support the conclusions reached by the auditor

Required;

a) List four benefits that the auditor would obtain from working papers that meet the above requirements (4 marks)

b) For each of the situations listed below, one form of audit evidence which is relevant and explain in each case whether that form of evidence is reliable and sufficient:-

i) A trade debtor shown in the balance sheet (4 marks)
ii) A batch of work-in-progress on the shop floor at the year end (4 marks)
iii) A contingent liability disclosed in the notes to the accounts (4 marks)

c) Briefly explain giving two examples, the quality of audit evidence generated by third parties (4 marks)

(Total: 20 marks)

QUESTION SIX

State the evidence which you, as the auditor, would like to find in place and pay attention to when vouching the following payments made by RR Paper Mills Ltd. during the financial year ended 31 October 2002.

a) Loans to three employees totalling Sh.6 million (4 marks)
b) The last call on 5,000 ordinary shares at Sh.15 per share (4 marks)
c) Fire insurance premiums amounting to Sh.10,000 paid for the office block (4 marks)
d) A loan amounting to Sh.30 million obtained from a local bank and secured by the factory building (4 marks)
e) Salesmen‘s commissions amounting to Sh.3,000,000 (4 marks)

(Total: 20 marks)

QUESTION SEVEN

a) State the basic elements of the scope paragraph of an audit report (4 marks)
b) Explain how auditors distinguish their responsibilities from those of the directors in respect of financial statements. (4 marks)
c) Explain the meaning of each of the following terms in relation to audit reports:
 i) Circumstances of uncertainty (4 marks)
 ii) Circumstances of disagreement (4 marks)
d) Distinguish between the —except for‖ and the —subject to‖ audit opinions (4 marks)

(Total: 20 marks)

QUESTION EIGHT

a) Your firm of accountants has been the auditors of Leather Merchants Limited, a company that exports both raw and semi-finished leather products to European and Asian markets. The company has decided to introduce a comprehensive computerised system to manage its accounting and administrative functions.

Required:

a) Outline the practical difficulties you would encounter as an auditor as a result of the proposed introduction of a computerised accounting system. (10 marks)
b) Explain how you would overcome the difficulties identified in (a) above (5 marks)

c) Identify and explain the benefits that the company would derive as a result of putting in place a comprehensive computerised accounting system (5 marks)

(Total: 20 marks)

2 December 2011. **Time allowed: 3 hours**

Answer any FIVE questions. All questions carry equal marks.

QUESTION ONE

(a) What is the purpose of a letter of representation? (4 marks)

(b) State and briefly explain the action auditors should take if the management refuses to provide a letter of representation. (4 marks)

(c) State the specific representations you, as an auditor, would wish to obtains from the management in respect of :

(i) Assets. (4 marks)

(ii) Liabilities. (4 marks)

(d) Identify any four contents of an audit engagement letter (4 marks)

(Total 20 marks)

QUESTION TWO

(a) Write brief explanation notes on each of the following terms:

(i) Audit risk. (2 marks)

(ii) Inherent risk (2 marks)

(iii) Control risk (2 marks)

(iv) Detection risk (2 marks)

(b) Identify the circumstances when it is appropriate to use only a substantive approach in an audit and when a combination of compliance and substantive tests should be used. (4 marks)

(c) List four advantages and four disadvantages of using the risk-based audit approach when auditing the financial statements of limited companies (8 marks)

(Total: 20 marks)

QUESTION THREE

The owner of a retail hardware shop has approached you for assistance in designing appropriate control procedures that would help in safe guarding the assets of the business against possible losses through theft and fraud. He is more particularly concerned about loss of cash and stocks. All sales are made across the counter and in cash only.

Required

For each of the following assets, suggest ten practical control procedures that the owner of the retail hardware shop should implement to minimise possible losses through theft and fraud:

(a) Cash (10 marks)

(b) Stocks (10 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Briefly explain the meaning of the term —control proceduresǁ. (4 marks)

(b) What is the importance of segregation of duties as a control procedure? (4 marks)

(c) In carrying out an audit, the auditor appraises the tests and the system of internal control in order to ascertain that it is capable of processing transactions or determining the quantities and values completely and accurately. The auditor further carries out substantive tests in an attempt to ensure that the transactions assets and liabilities recorded in the accounting records upon which the figures in the financial statements are based, are completely and accurately recorded.

Required

List and briefly explain the substantive tests the auditor would carry out to verify the values attributed to:

(i) Trade and debtors in a company's financial statements. (6 marks)
(ii) Trade creditors in a company's financial statements. (6 marks)
(Total: 20 marks)

QUESTION FIVE

(a) Briefly explain how an audit firm may use third party confirmations to provide evidence in relation to six difference balance sheet items. (12 marks)
(b) List two advantages and two disadvantages of using standardised audit programmes during audit assignments. (4 marks)
(c) Identify four factors that should be taken into consideration by an audit firm when allocating staff to audit assignments. (4 marks)
(Total: 20 marks)

QUESTION SIX

Auditors may be liable to shareholders and other parties who may have relied on the financial statements upon which the auditors have expressed an opinion. This is because the auditors are generally taken as owing a —duty of carell those parties and they could be liable in the tort of negligence if they failed that duty.

Required

(a) With reference to the external audit assignment, explain the meaning if the term —duty of carell (4 marks)
(b) Briefly explain the auditors' general responsibility. With regard to the prevention and detection of fraud and errors. (6 marks)
(c) State and briefly explain five possible measures that auditing firms should take in order to avoid legal actions for negligence against them. (10 marks)
(Total 20 marks)

QUESTION SEVEN

(a) Explain the factors that external auditors should consider in determining whether the financial statements of a limited company show a true and fair view. (8 marks)
(b) Identify six basic elements of the auditor's report containing an unqualified opinion on the financial statements. (6 marks)
(c) Briefly explain the types of audit opinion that would normally arise from a limitation in the scope of audit. (6 marks)
(Total 20 marks)

QUESTION EIGHT

(a) Identify five sections in which information technology can be used to enhance the administration procedures and controls over an audit (5 marks)

(b) Identify five audit benefits that could be derived from using Computer Assisted Audit Techniques (CAATs) when carrying out testing of computer records (5 marks)

(c) Briefly explain, giving an example in each case, five functions of an audit software interrogation programme (10 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATION BOARD

CPA

AUDITING

JUNE 2012 3 hours

Answer any FIVE questions. ALL questions carry equal marks.

QUESTION ONE

(a) List and briefly explain four objectives of an audit of financial statements. (8 marks)

(b) Outline and explain four ways in which the objectives of an audit of financial statements have changed over the years. (8 marks)

(c) It is often argued that: —The external auditor adds credibility to the financial statements produced by a business entity.‖

Briefly comment on this statement. (4 marks)

(Total: 20 marks)

QUESTION TWO

(a) Clearly outline the statutory responsibilities of an external auditor in relation to the audit of a company's financial statements. (6 marks)

(b) What are the responsibilities of the directors of a company in relation to a company's financial statements? (6 marks)

(c) (i)Briefly explain the nature and purpose of a letter of engagement. (4 marks)

(ii) Under what circumstances would it be appropriate for an external auditor to issue a new letter of engagement? (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) What are the objectives of an internal control system? (4 marks)

(b) Identify the basic division of duties one would expect to find in an internal control system. (4 marks)

(c) List the main control features one would expect to find in the following activities related to the buying function in an organization:

(i) Buying of goods (4 marks)

(ii) Receipt of goods (4 marks)

(iii) Payment of outstanding balances. (4 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Identify and explain four factors that would influence the size of a sample selected by an external auditor to enable him carry out a compliance test. (8 marks)

(b) In the context of audit sampling, distinguish between the following terms:

(i) Sampling risk and non-sampling risk (4 marks)

(ii) Tolerable error and expected error (4 marks)

(iii) Audit risk and detection risk (4 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Explain the importance of preparing regular bank reconciliation statements. (4 marks)

(b) Explain the reliability of bank statements as audit evidence. (4 marks)

(c) Outline the audit work you would undertake to obtain reasonable assurance that the following items appearing in the balance sheet of Ujuzi Ltd. are not materially misstated:

(i) Trade creditors (6 marks)

(ii) Specific provision for bad and doubtful debts. (6 marks)

(Total: 20 marks)

QUESTION SIX

(a) What are ―errors and irregularities‖ in the contest of an external audit of a limited company? (2 marks)

(b) Briefly explain the ways in which the directors of a company discharge their duties with regard to the prevention and detection of errors and irregularities. (8 marks)

(c) You have recently been appointed external auditor of ABC Ltd. What typical planning procedures would you undertake when planning the audit of ABC Ltd.? (6 marks)

(d) Identify four common problems that may hinder the proper implementation of an audit plan. (4 marks)

(Total: 20 marks)

QUESTION SEVEN

(a) What is the purpose of an audit report? (2 marks)

(b) List six contents of an unqualified audit report (6 marks)

(c) Identify and briefly explain four situations under which an auditor would consider qualification of his audit report. (8 marks)

(d) Explain the meaning of the following terms in relation to audit reports.

(i) Limitation in the scope of the audit. (2 marks)

(ii) Emphasis of matter (2 marks)

(Total: 20 marks)

QUESTION EIGHT

(a) What are computer assisted audit techniques (CAATs)? (3 marks)

(b) Briefly explain the following terms in relation to the audit of computerized accounting systems.

(i) Lack of visible evidence. (3 marks)

(ii) Systematic errors. (3 marks)

(iii) Test data (3 marks)

(c) Explain how you would use a computer audit programme to verify the year-end debtors balances. (8 marks)

(Total: 20 marks)

NOVEMBER 2004 **3 hours**

Answer any FIVE questions. ALL questions carry equal marks.

QUESTION ONE

(a) What is an —interim auditǁ? (2 marks)
(b) Identify any four circumstances under which an interim audit would be ideal. (4 marks)
(c) List and briefly explain five disadvantages of an interim audit. (10 marks)
(d) Suggest solutions to any four disadvantages you have identified in (c) above. (4 marks)

(Total: 20 marks)

QUESTION TWO

(a) Outline the professional guidelines that would assist the external auditor in avoiding being unduly dependent on a single client. (5 marks)
(b) Identify and briefly explain the statutory and ethical matters you would consider before accepting appointment as an auditor of a company. (10 marks)
(c) In the context of the Companies Act (Cap. 486), state the rights of an auditor. (5 marks)

(Total: 20 marks)

QUESTION THREE

An internal control system is designed to provide reasonable assurance that all the control objectives are being achieved.

Required:
What purpose does an internal control system serve in an organization? (6 marks)
Identify and briefly explain the three key elements of a good internal control system. (6 marks)
Identify and briefly explain any four inherent limitations of an internal control system. (8 marks)

(Total: 20 marks)

QUESTION FOUR

You are in charge of a group of audit trainees who have just been employed by your audit firm. This is the audit trainees‘ first assignment and they are aware that they are supposed to prepare audit working papers but they do not know how to do so or what information they should include in the audit working paper.‘

Required:
(a) Explain the importance of audit working papers. (4 marks)
(b) Provide the audit trainees with guidelines on how they should prepare audit working papers. (4 marks)
(c) Identify the type of information that the audit trainees should include in the audit working papers. (8 marks)
(d) List any four advantages of standardized audit working papers. (4 marks)

(Total: 20 marks)

QUESTION FIVE

Bafu Ltd., a private limited company, manufactures a wide range of bathroom fittings. These fittings are made from steel components which are chromed in small vats. The steel components are sourced from outside suppliers. The year end stock mainly consists of these steel components and finished items. As at 31 October 2004, the total stock was valued at

Sh. 6,048,000 out of total assets of Sh. 19,200,000. This stock figure was obtained by a physical count as at 31 October 2004, and valuation by reference to purchase invoices and manufacturing cost estimates.

Required:
With reference to each of the matters listed below, state the work you would do to conclude whether the amount attributed to stock is fairly stated.

(a) Quantities (5 marks)
(b) Identification of stock items (3 marks)
(c) Condition of stock items (2 marks)
(d) Cut-off procedures (5 marks)
(e) Valuation of stock (5 marks)

(2 marks)
(2 marks)
(2 marks)
(2 marks)

(Total: 20 marks)

QUESTION SIX

(a) Briefly explain the following terms as used in auditing:
(i) Vouching audit (ii)
Inherent risk. (iii)
Control risk
(iv) In depth audit tests.

(b) Explain the assurances that an auditor seeks to obtain in the audit of tangible fixed assets. (6 marks)

(c) Suggest six control measures that would help reduce the control risk associated with tangible fixed assets. (6 marks)

(Total: 20 marks)

QUESTION SEVEN

(a) (i) What is an audit peer review? (2 marks)
(ii) State and briefly explain the objectives of an audit peer review (6 marks)

(b) You are the auditors of Mount Elgon Ltd. You are carrying out a review of the accounts for the financial year ended 31 October 2004 with a view of signing the audit report. During this review, you have noted the following matters:

1. No depreciation has been provided on plant and machinery for the financial year ended 31 October 2004. This is because the directors of Mount Elgon Ltd. feel that the value of the plant and machinery is in excess of the amount at which it is stated in the financial statements.
2. Some sections of the company's stocktaking records were accidentally destroyed. Consequently, the value attributed to stocks as at 31 October 2004 is only an estimation by the directors of Mount Elgon Ltd.

Required:
(i) What would be your audit opinion with regard to the matter referred to in (1) above? (6 marks)
(ii) Draft an audit report expressing your specific reservations with regard to (2) above (6 marks)

(Total: 20 marks)

QUESTION EIGHT

(a) State and briefly explain an auditor's responsibilities with regard to the detection of errors and frauds. (8 marks)

(b) In the context of the audit of a computerized accounting system;

i. State and control objectives generally associated with the processing of data in a computerized accounting environment.' (6 marks)

ii. Identify the program controls which should be inbuilt in a computerized accounting system. (6 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA

AUDITING

May 2013 **3 hours**

Answer any FIVE questions. ALL questions carry equal marks.

QUESTION ONE

(a) You have recently been appointed as the external auditor of XYZ Ltd. Explain the stages you would in the conduct of your audit. (4 marks)

(b) In the context of the Companies Act (Cap. 486), outline the procedure for the removal of an auditor. (6 marks)

(c) The auditor should obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

Identify and briefly explain any three procedures for obtaining audit evidence. (6 marks)

(d) Briefly explain the meaning of the following terms in relation to audit reports:

(i) ―Except for‖ opinion. (2 marks)

(ii) Disclaimer of opinion. (2 marks)

(Total: 20 marks)

QUESTION TWO

(a) ―The auditor must not only be independent, but must be seen to be independent.‖ Briefly comment on this statement. (4 marks)

(b) Suggest how the independence of an auditor may be strengthened (4 marks)

(c) Explain the challenges that auditors face in the process of being independent. (4 marks)

(d) Outline the ways in which an auditor may be held criminally liable in the course of his audit duties. (6 marks)

(e) Briefly explain what is meant by ―the auditor‗s duty of due professional care.‖ (2 marks)

(Total: 20 marks)

QUESTION THREE

(a) The information acquired by the auditor from his client in the course of his professional work should not be disclosed to any third party except where consent has been obtained from the client.

Required:
Explain five circumstances under which an auditor can disclose such information to an appropriate authority without client‗s permission (5 marks)

(b) (i) Explain the meaning of the term ―audit committee‖ (2 marks)

(ii) List and briefly explain the main functions of an audit committee. (8 marks)

(c) Explain the purpose and principal contents of a letter of engagement (5 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Identify and explain the functions of the internal audit department in an organization. (4 marks)

(b) Outline and briefly explain the procedures that the internal auditor can conduct on behalf of the external auditor. (6 marks)

(c) State the factors that the external auditor should consider before placing reliance on the work of the internal auditor. (5 marks)

(d) Briefly explain the methods which an auditor might use to ascertain a client's internal control system. (5 marks)

(Total: 20 marks)

QUESTION FIVE

The auditor should prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the audit.

Required:

(a) State four benefits that an auditor would obtain from working papers that satisfy the above requirement. (4 marks)

(b) List five items of information you would expect to be contained in a permanent audit file and explain why each of these items of information should be readily available. (10 marks)

(c) In the audit or purchases, list four examples of the type of information that would be contained in the detailed audit working papers. (4 marks)

(d) Give any two reasons why a director should examine the directors' minute book. (2 marks)

(Total: 20 marks)

QUESTION SIX

(a) Cash in hand and cash at bank are commonly referred to as liquid assets. Because of this liquidity, these assets represent the most vulnerable of all the assets of an entity. You have recently been employed by Korir and Associates (Certified Public – Accountants) as an audit assistant. During your first audit assignment at Viwanda Ltd you have been allocated the audit of cash in hand and cash at bank.

Required

(i) State and explain any the audit procedures you would undertake in order to determine whether or not there has been any misappropriation of cash. (6 marks)

(ii) Explain any five controls over cash you would expect to be instituted by a business entity in order to minimize cases of embezzlement of cash, (5 marks)

(b) List the procedures you would follow to verify the following items:

(i) Petty cash balance. (3 marks)

(ii) Revaluation reserve. (3 marks)

(iii) Copyrights. (3 marks)

(Total: 20 marks)

QUESTION SEVEN

In the context of ISA 240 (The Auditor's Responsibility to Consider Fraud and Error in, an Audit of Financial Statements):

(a) Define: -
  (i) Fraud (3 marks)
  (ii) Error (3 marks)

(b) Outline the respective responsibilities of an entity's management and the external auditor with respect to the prevention and detection of fraud and error. (8 marks)

(c) Outline the procedures an external auditor should follow if he suspects that fraud; or error have been perpetrated. (6 marks)

(Total: 20 marks)

QUESTION EIGHT

Your are currently engaged in planning the audit of the payroll system of Ujenzi Ltd a manufacturing company, for the year ending 30 June 2005, Ujenzi Ltd's payroll system is fully computerized.

Required:

(a) Explain four ways in, which the use of a computerized payroll system by Ujenzi Ltd, would affect your work as the auditor. (8 marks)

(b) Explain three controls which should be instituted by Ujenzi Ltd to ensure that only authorized persons are allowed access to information on personal files and to input updates for the calculation of wages. (6 marks)

(c) Outline how audit tests could be performed ―around the computer‖ in relation to Ujenzi Ltd's payroll (4 marks)

(d) List any two fraudulent activities likely to be perpetrated in relation to Ujenzi Ltd's payroll (2 marks)

(Total: 20 marks)

CPA
SECTION II

AUDITING

December 2013 **Time allowed: 3 hours**

Answer any FIVE questions **ALL questions carry equal marks**

QUESTION ONE

a) In order to conduct an audit effectively and efficiently, an auditor should properly plan for the assignment

i) Explain the matters that an auditor should take into account at the planning stage of an audit exercise (8 marks)

ii) Outline the ways in which an auditor acquires knowledge about the client's business and industry (4 marks)

b) The final stage of an audit includes an overall review of the financial statements. Explain the procedures that the auditor should adopt for the final review. (4 marks)

c) Highlight the qualities required of the final accounts prepared by a client company. (4 marks)

(Total: 20 marks)

QUESTION TWO

a) The auditor must exercise due care and skill before he certifies that the financial statements show a true and fair view.

Explain the ways in which an auditor can minimize his potential liability for professional negligence. (10 marks)

b) Highlight the possible defences available to an auditor in a court of law who has been sued for failure to detect fraud in client's company. (5 marks)

c) In the context of the Companies Act, state the duties of an auditor. (5 marks)

(Total: 20 marks)

QUESTION THREE

a) Briefly explain how the auditor can use each of the following methods of sample selection when carrying out his audit assignment;

i) Stratified sampling (2 marks)

ii) Cluster sampling (2 marks)

iii) Haphazard sampling (2 marks)

iv) Block sampling (2 marks)

b) Explain the reasons why an auditor is not required to carry out a complete check of all the transactions and balances of a business (4 marks)

c) Identify the cases where an auditor is required to conduct a complete check of all the transactions and balances of a business. (4 marks)

d) Explain two reasons why an auditor should consider materiality when selecting a sample size. (4 marks)

(Total: 20 marks)

QUESTION FOUR

a) Explain the purpose of an internal control questionnaire to an auditor. (4 marks)

b) Explain the factors an auditor should consider when determining the adequacy of a client's internal control system. (6 marks)

c) Kenya Cans Ltd. Manufactures cans which are stamped from sheets of metal moulded and supplied to Selmont Ltd for packing fruits. After stamping the sheets of metal, scrap metal is produced as residue. During the year 2004, revenue from scrap metal amounted to Sh.500,000.

The company has established the following system to monitor the sale of scrap metal;

i) Scrap metal is placed by employees in a large bin outside the workshop
ii) At the of the week a local scrap dealer collects the scrap metal leaving the bin empty
iii) The scrap dealer takes the scrap metal to the gatekeeper who measures and records the weight in a register before it exits the factory.
iv) The scrap dealer sends a cheques the following week with a statement showing the weight collected, price and cheques amount. The company's cashier on receiving the cheques, compares it with the statement to ensure that they both agree with the gatekeeper's registers.

Required;
i) Explain the weaknesses of the above system. (4 marks)
ii) Suggest recommendations to improve on the above system. (6 marks)
(Total: 20 marks)

QUESTION FIVE

Your audit senior has assigned you the responsibility of auditing the stock of your client, XYZ Supermarket Ltd. for the year ending 31 December 2005.

The company's stock take is carried out once a year in the month of Novembersimultaneously for all the retail outlets.

Required:
a) State the audit assurances you would seek to obtain in the audit of stock. (4 marks)

b) Describe the audit procedures that you would perform in order to be satisfied as to the validity of the amount attributed to stock in the balance sheet of XYZ Supermarket Ltd. (12 marks) c) Define the word —bar coding‖ and explain its importance to XYZ Supermarket Ltd. (4 marks)
(Total: 20 marks)

QUESTION SIX

a) Your audit firm, Kimani and Associates has been contracted by the government to audit the procurement system followed by the government.

Required:
i) Identify the likely risk areas that your firm may encounter in the audit.(5 marks)

ii) Suggest possible measures the government can implement to strengthen the internal control system on procurements. (5 marks)

b) Outline the audit procedures an audit firm should follow in the verification of a manufacturing company‘s liabilities. (10 marks)

(Total: 20 marks)

QUESTION SEVEN

a) An auditor should form an opinion on the adequacy of the accounting treatment of an inherent uncertainty disclosed in the financial statements of a company.

i) What is meant by the term "inherent uncertainty"? (2 marks)
ii) Explain the treatment of inherent uncertainties in the auditor‘s report. (6 marks)

b) Summarise the principal contents of a statement of directors‘ responsibilities to be included in financial statements. (8 marks)

c) Explain the steps an auditor should take if he concludes that the client has made a departure from an accounting standard in the preparation of the financial statements. (4 marks)

(Total: 20 marks)

QUESTION EIGHT

a) The computerization of business operations has posed many challenges to the auditor.

Explain the difficulties experienced by an auditor in each of the following situations:

i) In the use of test packs. (4 marks)
ii) In on-line systems. (4 marks)
iii) When auditing the output of a complex computerized system. (6 marks)

b) Briefly explain how an auditor verifies the following items in a computerized system.

i) Standing data in a master file (3 marks)
ii) Alterations made in the computer programs. (3 marks)

(Total: 20 marks)

ANSWERS - PAST PAPERS

SUGGESTED SOLUTIONS TO THE PAST PAPER QUESTIONS

JULY 2008 PILOT PAPER

QUESTION ONE

a)

1. Consider the background to the clients business and ascertain any problem for that sector of the industry, which may affect his audit work.
2. Consider an outline plan of his audit including the extent to which he may wish to rely upon internal controls and the extent to which work can be allocated to interim or final audit stages.
3. Assess the effect of legislation or accounting practice on the financial statements of the client.
4. Review any management or interim accounts which the client may have preferred as these may indicate areas of concern in his audit.
5. Meet the senior management of the client to identify problem areas e.g. material variances between budgeted and actual results
6. Consider the timing of significant phases in the preparation of the financial statements e.g. dates of stock taking, balancing of personal ledgers, preparation of trial balance and draft accounts
7. Consider the extent to which the clients employees may be able to analyse and summarize the financial data and the relevance to his audit work carried out by the clients internal auditors.
8. Consider the need for expert advise
9. Determine the number and grade of audit staff to be allocated to each stage of the audit.
10. Consult members of the audit team to discuss any foreseeable problems. Often the partners will consult the manager who then becomes responsible for communication with other personnel used on that particular job.
11. A budget should be prepared allocating the time of each member or grade of the audit team. This budget should be used to control the time spent on that audit and any major variation investigated by the manager.
12. The client should be informed of the expected date of attendance by the auditor‘s staff and his agreement obtained.

b. ISA 300 ‗planning‘ states that the main objective of planning is to enable the audit to be performed in an effective manner.

The purposes of planning are:-

To ensure that appropriate attention is paid to the different areas of the audit. This involves, ensuring that adequate time, for example, is devoted to the audit of stocks, which are usually higher risk, and that petty cash which is usually lower risk, is not over audited.

- To ensure that potential problem areas are identified such as weaknesses in the control over creditors, which might lead to a material understatement.
- To facilitate review
- To assist in the proper allocation of work to the audit team
- Facilitates co-ordination of work done by other auditors and experts.

c) (i) & (ii)

Audit control involves three key elements: -

(i) Direction of audit staff
(ii) Supervision
(iii) Review of work done by staff.

Direction should be given to staff to whom work is delegated. Direction will involve informing staff on their responsibilities in a given audit and the objectives of audit procedures to be performed by them.

It also involves informing the staff of matters such as the nature of the entity's business on possible accounting and auditing problems that may affect the nature timing and extent of fraud involved.

Written audit programmes are used as important tools to communicate audit direction. Direction is effected using time budgets audit plans.

Supervision is related to both direction and review and is conducted as follows: -

1. An auditor should monitor the progress of his audit work to determine whether: -

    a) Staff have the necessary skills and competence to carry out the assigned task.
    b) Audit staff understands properly the audit instructions.
    c) Ensure that audit work is carried out in accordance with program and other planning documentation.

2. The partner should be informed of key significant questions raised during an audit to assess their significance and modify his audit programme where appropriate.

3. The partner should resolve any difference of professional judgment of audit personnel. Supervision required of an assignment will depend on the complexity of the assignment as well as the proficiency of audit staff. However, the reporting partner has to ensure that audit work has been performed to acceptable standards and that working paper provide adequate evidence of work that has been carried out.

AUDIT REVIEW

Audit work performed by each audit staff should be reviewed by personnel of high level competence to determine whether:

a) Such work has been performed in accordance with professional standards and guidelines
b) Audit work performed and results obtained have been documented
c) Any significant audit matters have not remained unresolved.
d) Audit objectives have been achieved and conclusions expressed are consistent with the results of audit work done and support his opinion of financial statements.

Another important technique in audit control is consultation in areas where matters of principle which are controversial, arise in which case the reporting partner should consult with other accountants, partner or independence specialists to resolve the issues.

Control is important in the final stages of an audit. In this case a checklist with sections to be filled by the reporting partner to achieve good audit control is used.

Quality Controls

This refers to the various policies and procedures put in place by the audit firm to ensure that the work carried out and opinion formed meets the audit standards as required by the ISA and the firms own quality standards.

Quality controls promote observation of personal standards relevant to audit work or described in Ethical statements published by professional bodies e.g. ICPAK. The auditor should ensure that he establish the best channel to communicate quality control to all levels of staff. Quality control policies are therefore the objectives and goals to ensure that quality audit work has been performed.

The following procedures provide assurance of achieving the objectives of quality control: -

i) Personnel policies:- Personnel in an audit firm should adhere to principles of objectivity and confidentiality.
ii) Skill and competence:- The firm should be staffed by personnel who have attained and maintained the skill and competence to enable them do their work.
iii) Audit assignment:- Audit work should be assigned to personnel who have the desired degree of technical training and proficiency required for the audit circumstances
iv) Direction and supervision:- This should be sufficient of audit work at all levels to provide the firm with reasonable assurance that work done by the firm meets the standards of quality established by the firm.
v) Acceptance and continuation of clients: The auditor should carry out an evaluation of audit clients prior to acceptance of audit assignments and should periodically review his association with existing clients so as to ensure that independence and ability to service such a client and achieve the proficiency of an audit is possible. In this case, the integrity of the clients management must be continuously assessed to avoid problems of auditing clients who lack integrity who are considered to be high risk clients.
vi) Review of working papers:- Each working paper should be signed and dated by the person who prepared. The final review of working papers should be done by the reporting partner which will enable the auditor to:

   a) Ensure that figures in the draft account make sense in the light of evidence gathered.
   b) Assess any impact of any unadjusted errors in the drafts and whether it maybe necessary to request further adjustments.
   c) To ensure that all appropriate disclosures and other requirements have been complied with in the statements.
   d) Ensure that there is relevant reliable and sufficient audit evidence to support the auditors opinion.

QUESTION TWO

a) Bank balances

i) The auditor should obtain the bank reconciliation statement as at the end of the period and perform the following procedures:
   - Verify that the reconciliation is accurately prepared;
   - Ensure that the correct balances as per the bank statement and the cash book have been picked in the reconciliation;
   - Verify that the reconciling items have subsequently cleared;
   - Ensure that there are no unexplained variances;

- Verify that all un-presented cheques had been dispatched to the payees and that all un-credited deposits have cleared.

This will assist the auditor in testing for window dressing. Window dressing in this context refers to attempts to overstate the liquidity of the company by keeping the cash book open such that money received after year end is credited to the cash book increasing the cash balance and reducing debtors. It could also take place by debiting cheques paid in the period under review but are not dispatched until after year- end.

This procedure of inspecting the bank reconciliation statement assists in verifying the completeness and accuracy of the bank balance.

ii) The auditor should obtain a direct confirmation from the bank of the amount holding on behalf of the client. The auditor should obtain the clients consent to communicate directly with the bank. Where consent is granted a standard letter of request should be sent to the bank.

The reply to this request is a good source of corroborative audit evidence to confirm the existence of the bank balance and other information such as the interest earned, any loans granted to the company or any restrictions placed on the operation of the account.

b) A contingency may be defined as a condition which exists at the balance sheet date where the ultimate outcome (gain or loss) will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events.

Probable losses should be accrued, possible losses should be disclosed and probable gains should be disclosed.

1. In relation to pending legal matters, I would:-

   a. Review the clients system of recording claims including the procedure for bringing them to the attention of management.
   b. Discuss with the legal department or company secretary the procedures for instructing solicitors.
   c. Examine board or management minutes for indications of possible claims
   d. Examine correspondence with solicitors, including bills rendered
   e. Obtain a list of matters referred to solicitors with the company's estimates of possible liabilities.
   f. Obtain a letter of representation from the relevant directors that he is not aware of any other matters referred to solicitors

2. Letter of representation: -

The knowledge of contingent liabilities may be confined to management and is therefore a suitable matter for inclusion in such a letter.

3. In relation to guarantees: -

Examine the memorandum and articles of association of the company to ascertain whether the company's directors have: -

i) Powers to give this guarantee to other parties.
ii) The maximum amount they can guarantee
iii) The parties they are allowed to guarantee.

a) Read through minutes of directors and ascertain whether a resolution was passed providing for this guarantee
b) Examine correspondence between the lender and client to ascertain:-

- Amount of loan guaranteed
- Interest on this loan
- Date when due
- Any special terms

c) Write to the party guaranteed and request his confirmation regarding the discharge of this liability. In case this is doubtful request client to provide for this liability

c) Petty cash

1) Examine the strength of the Internal Control System regarding petty cash payment.
2) Ensure that petty cash is maintained on an imprest system.
3) For all petty cash payments, a petty cash voucher should be raised and signed by the person using this amount and the authorization by a responsible officer and for this reason the auditor should take a sample of this vouchers and ensure that they are genuine.
4) The auditor should count petty cash at hand using surprise visits and should add back the amount spent to ensure that both items agree with the float.
5) For any deficit, the auditor should obtain a certificate of shortage from the petty cashier.
6) The auditor should not accept IOU's except if these were authorized by a responsible officer

Note: The key audit procedure is to carry out a cash count and to ensure the physical balance is reconciled to the ledger (testing for completeness, accuracy and existence).

d) Investment Income

This is received mainly from two sources i.e. fixed interest deposits and shares in listed companies.

(i) For fixed interest deposits, verify the overall income in the accounts by analytical review. In overall terms as the income is fixed, the expected income can be calculated. It is necessary to consider withholding tax deducted on the income.
(ii) For fixed interest deposits, test individual receipts to the cashbooks to ensure that the expected interest was received and check the calculations.
(iii) For shares in listed companies select a sample of investments and obtain from the company details of dividend payments made during the year or the dividend warrants.
(iv) Trace receipt of these dividends to the cashbook via dividend warrants.
(v) For shares in listed companies reconcile total income in accounts to total income in cashbook.
(vi) For shares disposed or purchased in the year check to clients broker note that all dividends to which the client was entitled have been received in the year.

QUESTION THREE

(a) Yes

i) As a result of developments in case law Donahue V Stephenson in 1932 to Hedley Byrne & Co. Ltd V Heller & Partners Ltd in 1963, auditors may be held to owe a duty of care to third parties under certain circumstances. A third party who suffers a loss through reliance on misleading audited accounts may bring an action for damages against the auditor in tort.

ii) Such a requirement would make auditors more vigilant in their work because of potential liabilities.
iii) Creates an avenue to compensate other users for lose occasioned by auditors negligence.
iv) Protection of public interests at large from fraudulent auditors.

Woolf J; in his judgment in the case of Jeb Fasteners Ltd V Mark Bloom & Co. identified the conditions to be met in actions under tort as follows :-

1. Foreseeability, by the dependent, of the plaintiff's.
2. Reliance by the plaintiff on the accounts
3. Negligence by the defendant in preparing, (auditing) the accounts.
4. Causation of loss suffered by the plaintiff in consequence of the negligence.
5. Quantum of the loss suffered by the plaintiff arising out of the defendants negligence.

(b) No

This is because every audit is different and what may be seen to be reasonable care and skill in one audit may not be for a different audit.

Thus to codify is to issue uniform exceptions of reasonable care and skill. This would be wrong, as the circumstances of every audit are different.

Thus, whatever is reasonable skill and care should be determined by an individual auditor by exercising his judgment depending on the circumstances of his audit.

(c) The auditor should be unwilling to take full responsibility for the detection of fraud during the annual audit as fraud is committed with the intention to conceal it. Thus, there is a great chance that even a well planned and properly carried out audit will be unable to detect fraud. This is especially if the fraud has been perpetrated by the management of the entity. In addition, an auditor carries out his work during a very short duration of the financial period. It would be unreasonable to expect him to review everything that took place during the year, a role that could be better played by management.

(d) The expectations gap should be reduced by the auditing profession since it is the profession, which suffers as a result of the gap. This is because, the users of the auditors report do not understand it and hence claims for negligence may be raised against the auditor.

A more detailed look at expectations gap follows:-

The Expectation Gap

There has been considerable discussion in recent years on the role of the auditor, and the _Expectation Gap'.

In general terms this can be described as the gap that exists between what the public, especially users of financial statements, believe auditors do (or ought to do) and what the auditors actually do. Such a gap usually surfaces on the unexpected failure of a company.

Various elements of this gap have been identified

(a) A Standard gap
Where the public perceive auditing standards as different from what they actually are.

(b) A performance gap
Where auditors perform below existing standards.

(c) A liability
Where the public does not know to whom an audit is legally responsible.

Potential ways of closing the gap

(a) Understanding financial statements and the audit report

False or unrealistic expectations in users of financial statements are frequent. They may not appreciate the conventions on which accounts are prepared, the inevitable degree of estimation and judgment involved or the test nature of audit work.

Communication with these users to improve their understanding could be improved. The most significant work on this area has been ISA700 Auditors' Reports on Financial Statements, which requires the auditor's report to define the responsibilities of the auditor and the directors in relation to the financial statements.

(b) **Fraud**
When questioned, a high proportion of the public believes that the auditor has a responsibility to detect fraud of all kinds, or that he should actively search for fraud. However, deep-seated fraud with wide collusion maybe virtually impossible to identify, given the limitations of audit techniques. The auditor may not reasonably be expected to have discovered a particular fraud in particular circumstances.

Once again, the profession should attempt to explain these limitations to the users of accounts, so that they are aware of the auditor's responsibility is to have only a ‗reasonable expectation' of detecting material fraud.

Alternatively the auditor could be required to limit the opportunity for fraud in the first place. Requirement could be set for companies and their auditors to review the effectiveness of controls to prevent material fraud, and to report material deficiencies.

(c) **Control of the auditing profession**

At a national level, legislation to control auditors varies. At an international level IFA produces ISA'S and ethical guidance which influences good practice. However these pronouncements are not legally enforceable.

Audit failures are sometimes due to poor performance. Education (keeping up to date) should remedy this. Legal action and disciplinary proceedings serve as a warning.

QUESTION FOUR (DECEMBER 1997 QUESTION 6)

(a) Materiality is defined in ISA 320 to be the expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors report. Materiality is not capable of general mathematical definition as it has both quantitative and qualitative aspects.

The auditors' responsibility is to plan and perform their audit to obtain reasonable assurance that the financial statements are free of material misstatement and give a true and fair view. Thus anything that would distort the view given by accounts must lead to a qualification, but only if it is material.

(b) The duty of confidentiality requires that information acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source, or where there is a legal or professional right or duty to disclose.

A member acquiring information in the course of professional work should neither use nor appear to use that information for his personal advantage or for the advantage of a third party.

Where a member is in any doubt, the matter if appropriate should initially be discussed fully within his firm or organization. If not appropriate, or if it fails to resolve the problem, he should consider taking legal advice and/or consult ICPA (K)

Confidentiality in practice

An accountant should only act for a client on the understanding that the client will make full disclosure to him. In the absence of such an understanding the accountant should decline the appointment.

If during the course of an engagement, the client fails to furnish all the information considered necessary, the accountant should disclose this in his report. The accountant should also consider whether he can continue to act.

Sometimes in the course of his work an accountant may obtain information from a client that has a bearing on information supplied to him by another client.

In such circumstances, it would be breach of confidence to reveal the information to the second client without the permission of the first client.

The accountant should instead endeavour to substantiate the information with evidence obtained directly from the books and records of the second client. This may necessitate direct confirmation. Ultimately he may have to qualify his report or resign.

(c) A part of gross income of the auditing firms is paid to insurance firms as part of professional indemnity insurance (PII) such that when negligence claims are brought against the audit firm, then the insurance will settle these claims.

Some professional bodies require their members in public practice to hold PII covering all civil liability incurred in connection with the conduct of the firm's business by partners, directors or employees. This means that if a client or other party successfully sues the firm for negligence, then the firm will not meet the claim but the insurer will. So if the firm is unable to pay a very large claim, the insurance will have the required resources.

(d) Peer review: A system where one firm of auditors reviews the working practices of another.

The work of the review is limited to: -

a) Professional aspects of the practice.
b) Overall quality control policies
c) Professional aspects of firm's accounting and auditing practices like maintenance of working papers work products such as financial statements.

(e) Quality controls

ISA 220, —Quality control for audit work requires that all firms implement quality control policies and procedures at the levels of the audit firm, and on individual audits. Those policies and procedures should be communicated to staff, via formal policy statements, audit manuals and informal briefings, and monitored to ensure that they are implemented.

Quality controls ensure the audit is carried out: -

- In accordance with international accounting standards.
- In conformity with statutory and contractual requirements
- In accordance with ethnical standards.

QUESTION FIVE

The question requires you to describe to Mr. Charo the legal, ethical and practical factors your firm would consider before accepting the appointment. This implies that you must touch on the company's Act provisions and the guidelines issued by ICPAK.

a) Before your firm accepts appointment the following factors should be considered:

Statutory matters

Ensure that your firm is professionally, legally and ethically qualified to act as an auditor. The auditor must ensure that he has not contravened any provisions of the companies Act in regard to independence. He must ensure that he is not a servant or in partnership with a servant of the company. In case the company has a holding company or subsidiaries it is also important to ensure that your firm has not previously been disqualified from being eligible for appointment as auditors of such subsidiaries or the holding company.

Ethical matters

- Your firm must also ensure that it has fulfilled all the professional ethical requirements in regard to independence. I.e. the firm must not have any personal, family or business relationships with the prospective client among other provisions;

- Your firm should establish it has the technical proficiency to undertake the audit. This will include determining whether the firm posses the necessary technical skills to carry out the assignment;

- Establish whether the firm's resources are adequate to service the needs of the new client i.e. staff time with the necessary technical competence and experience;

- Your firm should seek references about the status of the company and its management. Such references will assist the auditor in assessing the potential risk in associating with this new client. Information sought would include the reputation of the company and its directors. It is a professional requirement that very firm must evaluate all prospective clients before accepting appointment. Seeking references about the client provides useful information in carrying out this evaluation;

- I would try to determine the reason for the change in auditor. The question says that the directors believe they do not receive a cost effective service from the existing auditor. However, there may be problems with the level of audit fee or the existing auditor may want to qualify his report which the directors are trying to prevent;

- I would obtain a copy of the previous years audited accounts. If the audit report is qualified, it indicates that the audit has a higher than normal risk. From these accounts I would assess whether the company is having going concern problems by calculating appropriate ratios such as the gearing ratio and if there could be weaknesses in the system of internal control;

- I would check that no conflict of interest arises through my acceptance of appointment as auditor of the company;

- I would consider the level of fee I would charge. It should be sufficient to provide an acceptable return, as an inadequate fee could result in insufficient audit work being carried out and thus increase the audit risk;

- Communicate to the outgoing auditor-Your firm should request the client‘s permission to communicate with the existing/outgoing auditor. If such permission is denied your firm should decline the appointment. If your firm receives permission from the client, you should write to the existing auditor requesting all the information which ought to be made available to you to enable you decide whether or not you are prepared to accept appointment. Communication with the existing auditor is not just a matter of professional courtesy. Its main purpose is to enable the prospective auditor ensure that there are no reasons which preclude him from accepting the appointment. It would be important at this stage to confirm with the outgoing auditor whether the true reason for being requested to resign is because their firm is perceived by management as not providing a value for money audit or could there be other reasons behind this.

  Before replying to the prospective auditor the outgoing auditor should obtain the client‘s permission to discuss his affairs fully with the prospective auditor. If the outgoing auditor is duly authorized by the client to discuss the client‘s affairs with the prospective auditor, then he may communicate any relevant information he believes to be true, including the reasons for the proposed change and any other matter he considers that the prospective auditor should be made aware.

  The prospective auditor must treat any information given by the outgoing auditor in the strictest confidence and should weigh this carefully in reaching a decision whether or not to accept the appointment.

  If the client refuses the existing auditor authority to discuss his affairs with the prospective auditor, the outgoing auditor should inform the prospective auditor who should then decline the appointment.

  If the outgoing auditor considers that there are professional reasons to prevent the prospective auditor accepting nomination he must disclose these to the prospective auditor. The prospective auditor should endeavor to ascertain the reasons for the change in auditors. If after doing this, he is of the opinion that the existing auditor is being treated unfairly, he may decline the appointment.

  Therefore communicating with the outgoing auditor is important:

- To get necessary information that could guide him on whether to accept or reject nomination;
- To enquire on the reasons for the change in auditors;
- Professional courtesy.

Having considered these factors your firm should then make a decision on whether to accept the appointment.

After your firm accepts nomination it should carry out the following procedures

- Ensure that the removal or resignation of existing auditor is properly carried out in accordance with the Companies Act Chapter 486. I.e. a simple resolution was passed at the AGM removing the current auditors.
- That your appointment is valid and obtain a copy of new resolution passed in AGM to appoint you as the new auditor.
- Set up a letter of engagement to the directors of company.

B) **Disqualification for Appointment**

Section 161 (1)

A person or a firm shall not be qualified for appointment as an auditor of a company or in the case of a firm, every partner of the firm is a holder of a practicing certificate pursuant to Section 21 of the accountants act 1977 and such a certificate issued under the following conditions

a) A person with CPA III
b) A person with at least 3 year post graduate experience
c) A person registered with RAB
d) A person registered with KASNEB
e) A person who is a member of ICPAK

Section 161 (2)

None of the following persons shall be qualified as a n auditor of a company:-

1. A servant of a company
2. A person who is a partner or is in employment of an officer or servant of a company
3. A body corporate

Section 161 (3)

A person cannot be qualified for appointment if he has by virtue of subsection (2) above been disqualified as an auditor of a body corporate which is that company‘s subsidiary or holding company or subsidiary of the company‘s holding company or would be disqualified if the body corporate were a company.

Section 161 (4)

If any person not qualified as an auditor of a company acts as one, then such a person or an officer of the company in default shall be liable to a default fine not exceeding 4,000/=

Qualification of an auditor under the Accountant Act Cap 531 Section 21

A person shall be qualified to be an auditor of a company if such a person or in the case of a firm all partners are members of one of the professional bodies specified in the first column of the Accountants Act e.g. ICPA (K), ACCA, ICAEW. This is necessary because:-

a) These bodies are watchdogs over professional ethics of their professionals.

b) They ensure that their members keep up with professional competence in the latest developments in the accounting profession through continuous professional education:-

- If the person is a holder of the final certificate of a recognized professional board.
- If the person is registered with RAB
- If the person has at least a two year of post graduate experience in an audit environment
- If the person is registered with KASNEB

QUESTION SIX

An investigation may be defined as an inquiry into the financial affairs of a business, including the examination of its audited accounts for recent years and its current and estimated future position as will enable the investigating accountant to ascertain and Marshal in his report the information relevant to the investigation.

The nature and scope of a fraud investigation are dependent on the instructions given. The main problems usually are:

a) The past time period that needs to be investigated. This could be a few or many years.
b) The scope of the investigation. We have to determine whether we are investigating an individual, a whole company, a whole department or a group of companies.
c) The question of individuals. This can be a very painful exercise and the following general rules can be helpful:

   i. The questioner should have a colleague present;
   ii. The person being interviewed should be allowed to have a friend present;
   iii. Accusations should not be made but evidence should be presented and explanations requested;
   iv. The questioning should be in private;
   v. If necessary, judge‘s rule should be observed. This means that a person being questioned understands the nature of the question and should not unwittingly incriminate himself;

There are two categories of fraud

a) Fraud involving the manipulation of the records and the accounts usually by the company‘s senior officer with a view to benefiting in some way from the false picture which they convey.
b) Frauds usually by employees involving the theft, misappropriation or embezzlement of the company‘s funds usually in the form of cash or other assets.

Below is a summary of procedures the investigating accountant will be required to follow in arriving at estimates of losses from case (b), assuming that it is already known that a defaulting employee has been at work..

i. He has to ascertain the level of authority and the nature of duties of the defaulting employee;
ii. Cast and vouch the cashbook and obtain certificates of opening and closing balances from the bank.
iii. Check the cash book against bank statements paying particular attention to the dates of lodgement to ascertain whether receipts were banked promptly;
iv. Examine pay-in-slips at the bank and compare with counterfoils as these may reveal teeming and lading.
v. Carry out a positive circularisation of debtors;
vi. Review the cash book for any apparently irregular payments;
vii. Examine return cheques comparing names or payees with the details in the cash book and invoices;
viii. Obtain duplicates of missing expenditure vouchers;
ix. Vouch all amounts shown as partners or directors‘ drawings or loans;
x. Vouch and cast the petty cash book;
xi. Confirm names of all employees shown on payroll with the chief accountant and the personnel manager and confirm amounts payable to them;
xii. If the defrauder has access to all books then postings should be checked and a tail balance extracted;
xiii. Confirm all bad debts written off, discounts allowed and returned goods;
xiv. Check the order book against the sales daybook, or copy sales invoices in order to detect any unrecorded sales;
xv. Vouch purchase invoices with purchases daybook, and see that none of them has been processed twice;
xvi. Obtain duplicates of all missing purchase vouchers;
xvii. Compare the creditors statements against purchase ledger balances;
xviii. Check goods inwards book or order against invoices to ensure that the latter relate genuine purchases.

The cashier who keeps books of accounts might have misappropriated cash in any of the following ways:
1. Omitting to enter the receipt of cash
2. Entering less amount in the cash book than what has been received
3. Showing fictitious payments
4. Entering more amount in the cashbook than what has actually been paid

The investigator should follow the line of actions detailed below:-

1. Permission should be obtained from his client to issue a circular to the debtors and creditors asking them to confirm the balance owing by them or to them respectively.
2. He should pay attention to cash sales and see whether there is a loop hole. If so, he must probe into the matter.

The investigator should pay special attention to the following points:-

1. Remuneration of the directors, managing agents etc
2. Whether the funds of the company are properly and profitably employed.
3. Loans advanced to the directors of the company interest charges thereon, and the security offered by such a director.
4. The current account of the managing agents with the company

5. The contracts entered into by the managing agents with other companies in which such managing agents or directors are interested.
6. The assets and liabilities should be verified and valued.

QUESTION SEVEN

(a) Basic elements of the unqualified audit report.

Describe clearly the circumstances in which an adverse opinion and a disclaimer of opinion would be appropriate and give two examples, one each, to illustrate your answer. (A full audit opinion is not required).

1. Title

   Audit reports should be addressed to the members of the company on whose behalf the audit is undertaken.

2. Introductory paragraph

   It identifies the financial statements audited to distinguish such information from other documents that have not been subject to audit e.g. chairman's report.

   This paragraph also refers to the accounting convention under which the financial statements have been prepared.

3. Statement of responsibility of directors and auditors. This states that it is the responsibility of the directors to prepare financial statements that show a true and fair view.

4. Basis of opinion (scope paragraph)

   Audit carried out in accordance with IAS, ISA and Company's Act requirement and other statutory requirements.

5. A statement that the audit was planned and performed to obtain reasonable assurance that financial statements are free from material misstatements.

6. It should describe an audit as including:

a. Examining on a test basis evidence to support the financial statement amounts and disclosures.
b. Assessing the accounting policies used in preparing the financial statements
c. Assessing the significant estimates made by directors in preparation of financial statements.
d. Evaluating the overall financial statement presentation.

7. It should clearly state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with financial reporting framework and their compliance with statutory requirements. In particular whether the balance sheet and the profit and loss account show a true and fair view of the state of the financial position of the company and its financial performance.

8. It should date the report as of audit completion date i.e. when the auditor receives all evidence required to support his opinion.

9. It should be signed in the audit firm's name and should name the audit firm office.

b) The ISA attempt to ensure that the report of the auditors is clearly understood by giving guidelines to auditors as to how the report should be constructed and what details it should contain. This supplements the requirements of the companies Act and ensures that the audit report is well understood by the users of the audited financial statements.

For example it requires auditors to: -

i) Identify the financial statements to which the report covers.
ii) Describe the scope of an audit as having been conducted in accordance with ISA's or relevant national standards.
iii) A statement describing the audit as including:-

- examining on a test basis evidence to support the financial statement amounts and disclosures
- assessing the accounting principles used in the preparation of the financial statements
- assessing the significant estimates made by management in the preparation of the financial statements
- evaluating the overall financial statement and also that the audit provides a reasonable basis for the opinion.

iv) A paragraph educating the users of the report on the responsibilities of the auditor and the directors responsibility regarding the financial statements.

c) A disclaimer of opinion is issued when there is a limitation in the scope of the audit or an inherent uncertainty that is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion.
A limitation in the scope of the auditors work may be caused by: -

- The entity e.g. when his engagement terms specify that he will not carry out what he believes to be necessary.
- Circumstances e.g. where the appointment of the auditor is after stock taking and therefore the auditor is unable to observe the exercise.
- Inability to carry out audit procedures believed to be desirable.

A disclaimer of opinion could be issued when the accounting records of a client are destroyed by fire or become corrupted (when held on soft copy) making it difficult to obtain the required information or where management refuses to give the auditor information on an issue that is fundamental to the financial statements.

Adverse opinion

This is expressed when the effect of a disagreement is so material and that a qualification of reports is not adequate to disclose the misstatement or incompleteness of financial statements.

Auditors may disagree with management regarding: -

- The acceptability of accounting policies selected
- Methods of application of accounting policies
- Adequacy of financial statement disclosures.

An example when an adverse opinion is required is when the management refuses to make a provision for a contingent liability whose crystallisation appears imminent or write off a bad debt.

QUESTION EIGHT

CIS ENVIRONMENTS – DATABASE SYSTEMS

a) This question required the students to have a thorough understanding of the database. Since this is an area that has not been covered in sufficient depth by students at this level, ISA 1003, CIS environment – data based systems is reproduced in its entirety below

In relation to this question, paragraphs 16,17,18,19,20 & 21 suffice.

1. The purpose of this statement is to help the auditor implement ISA 400 ―Risk Assessments ad Internal Control,‖ and Internal Auditing Practice Statement 1008 ―Risk Assessments and Internal Control – CIS Characteristics and Considerations,‖by describing database systems. The Statement describes the effects of a database system on the accounting system and related internal controls and on audit procedures.

Database Systems

2. Database systems are comprised principally of two essential components – the database and the database management system (DBMS). Database systems interact with other hardware ad software aspects of the overall computer system.

3. A database is a collection of data that is shared and used by a number of different users for different purposes. Each user may not necessarily be aware of all the data stored in the database or of the ways that the data may be used for multiple purposes. Generally, individual users are aware only of the data that they use and may view the data as computer files utilized by their applications.

4. The software that is used to create, maintain and operate the database is referred to as DBM software. Together with the operating system, the DBMS facilitates the physical storage of data, maintains the interrelationships among the data, and makes the data available to application programs. Usually, the DBMS software is supplied by a commercial vendor.

5. Database systems may reside on any type of computer system, including a microcomputer system. In some microcomputer environments, database systems are used by a single user. Such systems are not considered to be databases fro the purposes of this Statement. The contents of this Statement, however, are applicable to all multiple user environments.

Database System Characteristics

6. Database systems are distinguished by two important characteristics: data sharing and data independence. These characteristics require the use of a data dictionary (paragraph 10) and the establishment of a database administration function (paragraphs 11-14).

Data Sharing

7. Database is composed of data which are se up with defined relationships and are organized in a manner that permits many users to use the data in the database for different purposes. For example, an inventory item unit cost maintained by the database may be used by one application program to produce a cost of sales report and by another application program to prepare an inventory valuation.

Data Independence From Application Programs

8. Because of the need for data sharing, there is a need for data independence from application programs. This is achieved by the DBMS recording the data once for use by various application programs. In non-database systems, separate data files are maintained for each application and similar data used by several applications may be repeated on several different files. In a database system, however, a single file of data (or database) is used by many applications, with data redundancy kept to a minimum.

9. DBMS's differ in the degree of data independence they provide. The degree of dataindependence is related to the ease with which personnel can accomplish changes to application programs or to the database. T rue data independence is achieved when the structure of data in the database can be changed without affecting the application programs, and vice versa.

Data Dictionary

10. Significant implication of data sharing and data independence is the potential for the recording of data only once for use in several applications. Because various application programs need to access this data, a software facility is required to keep track of the location of the data in the database. This software within the DBMS is known as a data dictionary. It also serves as a tool to maintain standardized documentation and definitions of the database environment and application systems.

Database Administration

11. the use of the same data by various application programs emphasizes the importance of centralised coordination of the use and definition of data and the maintenance of its integrity, security accuracy and completeness. Coordination is usually performed by a group of individuals whose responsibility is typically referred to as —database administration.‖ The individual who heads this function may be referred to as the—database administrator‖. The database administrator is responsible generally for the definition, structure, security, operational control and efficiency of databases, including the definition of the rules by which data are accessed and stored.

    1. Database administration tasks may also be performed by individuals who are not part of a centralized database administration group. Where the tasks of database administration are not centralized, but are distributed among existing organizational units, the different tasks still need to be coordinated.

    2. Database administration tasks typically include:

        - Defining the database structure – determining how data are defined stored and accessed by users of the database in order to ensure that all their requirements are met on a timely basis.

        - Maintaining data integrity, security and completeness-developing, implementing and enforcing the rules for data integrity, completeness and access. Responsibilities include:

        - Defining who may access data and how the access is accomplished (i.e., through passwords and authorization tables);
        - Preventing the inclusion of incomplete or invalid data;
        - Detecting the absence of data;
        - Securing the databases fro unauthorized access and destruction; and

- Arranging total recovery n the event of a loss.

- Coordinating computer operations related to the database-assigning responsibility for physical computer resources and monitoring their use relative to the operation of the database.

- Monitoring system performance-developing performance measurements to monitor the integrity of the data and the ability of the database to respond to the needs of users.

- Providing administrative support-coordinating and liasing with the vendor of the DBMS, assessing new releases issued by the vendor of the DBMS and the extent of their impact on the entity, installing new releases and ensuring that appropriate internal education is provided.

3. In some applications, more than one database may be used. In these circumstances, the tasks of the database administration group will need to ensure that:

- Adequate linkage exists between databases;
- Coordination of functions is maintained: and
- Data contained in different databases are consistent.

Internal Control in a Database Environment

4. Generally, internal control in a database environment requires effective controls over the database, the DBMS and the applications. The effectiveness of internal controls depends to a great extent on the nature of the database administration tasks, described in paragraphs 11 – 14, and how they are performed.

5. Due to data sharing, data independence and other characteristics of data-base systems general computer information systems (CIS)[2] controls normally have a greater influence than CIS controls over the database, the DBMS and the activities of the database administration function have a pervasive effect on application processing. The general CIS controls of particular importance in a database environment can be classified into the following groups:

- Standard approach for development and maintenance of application programs;
- Data ownership;
- Access to the database; and
- Segregation of duties

Standard Approach for Development and Maintenance of Application Programs

6. Since data are shaded by many users, control may be enhanced when a standard approach is used for developing each new application program and for application program modification. This includes following a formalized step-by-step approach that requires adherence by all individuals developing or modifying an application program. It also includes performing an analysis of the effect of new and existing transactions on the database each time a modification is required. The resulting analysis would indicate the effects of the changes on the security and integrity of the database. Implementing a standard

approach to develop and modify application programs is a technique that can help improve the accuracy, integrity and completeness of the database.

Data Ownership

7. In a database environment, where many individuals may use programs to input and modify data, a clear and definite assignment of responsibility is required from the database administrator for the accuracy and integrity of each item of data. A single data owner should be assigned responsibility for defining access and security rules, such as who can use the data (access) and what functions they can perform (security). Assessing specific responsibility for data ownership helps to ensure the integrity of the database. For example, the credit manager may be the designated ―owner‖ of a customer‗s credit limit and would therefore be responsible for determining the authorized users of that information. If several individuals are able to make decisions affecting the accuracy and integrity of given data, the likelihood increases of the data becoming corrupted or improperly used.

Access to the Databases

8. User access to the database can be restricted through the use of passwords. These restrictions apply to individuals, terminal devices and programs. For passwords to be effective, adequate procedures are required for changing passwords, maintaining secrecy of passwords and reviewing and investigating attempted security violations. Relating passwords to defined terminal devices, programs and data helps to ensure that only authorized users and programs can access, amend or delete data. For example the credit manager may give salesmen authority to refer to a customer‗s credit limit, whereas a warehouse clerk may have such authorization.
9. User access to the various elements of the database may be further controlled through the use of authorization tables. Improper implementation of access procedures can result in unauthorized access to the data in the database.

Segregation of Duties

10. Responsibilities for performing the various activities required to design, implement and operate a database are divided among technical, design, administrative and user personnel. Their duties include system design, database design, administration and operation. Maintaining adequate segregation of these duties is necessary to ensure the completeness, integrity and accuracy of the database. For example those persons responsible for modifying personnel database programs should not be the same persons who are authorized to change individual pay rates in the database.

The Effect of Databases on the Accounting System and Related Internal Controls.

11. The effect of a database system on the accounting system and the associated risks will generally depend on:

- The extent to which databases are being used by accounting applications;
- The type and significance of financial transactions being processed;
- The nature of the database, the DBMS (including the data dictionary), the database administration tasks and the applications (e.g. batch or on-line update); and

- The general CIS controls which are particularly important in a database environment.

12. Database systems typically provide the opportunity for greater reliability of data than non-database systems. This can result in reduced risk of fraud or error in the accounting system where databases are used the following factors, combined with adequate controls, contribute to this improved reliability of data:

    - Improved consistency of data is achieved because data are recorded and update only once, rather than in non-database systems, where the same date are stored in several files and updated at different times and by different programs.
    - Integrity of data will be improved by effective use of facilities included in the DBMS, such as recovery, restart routines, generalized edit and validation routines, and security and control features.
    - Other functions available with the DBMS can facilitate control and audit procedures. These functions include report generators which may be used to create balancing reports, and query languages which may be used to identify inconsistencies in the data.

13. Alternatively risk of fraud or error may be increased if database systems are used without adequate controls. In a typical non-database environment, controls exercise by individual users may compensate for weaknesses in general CIS controls. However, in a database system, this may not be possible, as inadequate database administration controls cannot always be compensated for by the individual users. For example, accounts receivable personnel cannot effectively control accounts receivable data if other personnel are not restricted from modifying accounts receivable balances in the database.

The effect of Databases on Audit Procedures

14. Audit procedures in a database environment will be affected principally by the extent to which the data in the database are used by the accounting system. Where significant accounting applications use a common database, the auditor may find it cost-effective to utilize some of the procedures in the following paragraphs.

15. In order t o obtain an understanding of the database control environment and the flow of transactions, the auditor may consider the effect of the following on audit risk in planning the audit:

    - The DBMS and the significant accounting applications using the database;
    - The standards and procedures for development and maintenance of application programs using the database;
    - The database administration function;
    - Job descriptions, standards and procedures for those individuals responsible for technical support, design, administration and operation of the database;
    - The procedures used to ensure the integrity, security and completeness of the financial information contained in the database; and
    - The availability of audit facilities within the DBMS.

16. During the risk assessment process, in determining the extent of reliance on internal controls related to the use of databases in the accounting system, the auditor may consider how the controls described in paragraphs 17 – 21 are

used in the system. If he subsequently decides to rely on these controls, he would design and perform appropriate compliance tests.

17. Where the auditor decides to perform compliance or substantive tests related to the database system, audit procedures may include using the functions of the DBMS (see paragraph 23) to:

- Generate test data;
- Provide an audit trail;
- Check the integrity of the database;
- Provide access to the database or a copy of relevant parts of the database for the purpose of using audit software (see International Audit Practice Statement 1009 —Computer-Assisted Audit Techniques‖); or
- Obtain information necessary for the audit.

When using the facilities of the DBMS, the auditor will need to obtain reasonable assurance regarding their correct functioning.

18. Where the auditor determines he cannot rely on the controls in the database system, he would consider whether performing additional substantive test on all significant accounting applications which use the database would achieve his audit objective as inadequate database administration controls cannot always be compensated for by the individual users.

The characteristics of database systems may make it more effective for the auditor to perform a pre-implementation review of new accounting applications rather than to review the applications after installation. This pre-implementation review may provide the auditor with an opportunity to request additional functions, such as built-in audit routines, or controls within the application design. It may also provide the auditor with sufficient time to develop and test audit procedures in advance of their use.

b) In my preliminary evaluation of controls over sales and debtors I would carry out tests of controls, which would be designed to check that control procedures are being applied and that control objectives are being achieved. The questions I would raise include the following:

i) Whether there is a proper credit control department that carries out the following functions:

- Evaluates the credit profile of the customer before awarding credit facilities to a customer.
- Recommends to management the terms of credit to be awarded to the various customers. This would include determining the credit limit, the number of days allowed and any other special terms such as award of discounts;
- Follows up accounts when they fall due for payment and recommends action to management of overdue accounts.

ii) Whether all sales orders are authorised by a senior responsible official. Before the orders are authorised whether the customer's account has been checked to ensure that the customer is operating within the credit limit.

iii) Whether there are controls to ensure that all sales are subsequently invoiced. This will include the use of pre-numbered dispatch records and a person to check whether all goods dispatched are subsequently invoiced;

iv) I would also seek to establish whether there is a person who reviews the invoices to ensure that the customer has been billed at the correct sales prices.

v) I would seek to establish what procedures are in place to ensure that all sales to customers and payments received from such customers are subsequently recorded in the ledger.

vi) I would also seek to establish whether the customers statements are reconciled to the ledger before being sent to the customer on a monthly basis.

vii) I would seek to establish whether there are proper follow up procedures for overdue accounts and write off of bad debts.

DECEMBER 2008

QUESTION ONE

a) The details that should b contained in each working paper prepared by an auditor include:

- The audit objective that the auditor is trying to test by the information contained in the working paper;
- Details of the source of information documented in the working paper;
- Details of the person who prepared the working paper;
- Details of review of the working paper
- The date of preparation

b) Each client schedule used as a working paper should indicate:

- The client personnel who prepared the working paper;
- The date of preparation

c) An audit programme should include the following:

- The accounting area or balance to which the audit programme relates to;
- The audit objective that the auditor is testing;
- The audit procedures to be carried out;
- The conclusion on the audit objective basing on the evidence obtained;
- The details of the person who prepared the programme, the reviewer and date of review.

d) A permanent audit files contains information that is relevant for more than one financial year i.e information that is useful to the auditor for more than one financial year and is not specific to a single financial period. For example the letter of engagement is contained in a permanent audit file. The engagement letter contains the terms of the contract between the auditor and the client. This information is required by the auditor in every financial period.

On the other hand the current audit file contains information that is relevant for the current financial period under audit. For example confirmations obtained from debtors are only relevant for the specific financial period being audited.

Audit working papers provide evidence on the audit objective that the auditor was testing, information obtained in relation to that audit objective and the conclusion drawn by the auditor as supported by the evidence documented in the working papers.

QUESTION TWO

a) The purpose of requiring that mail is opened by two persons

- To ensure that all receipts by mail are accounted for. The two persons will over look the activities of each other to ensure that all collections are recorded;
- To reduce the risk that one individual could be tempted to conceal some of the receipts and latter misappropriate the collections;
- To ensure that the receipts are accurately recorded. One person will counter check to ensure that the receipts are correctly recorded.

The tests of controls that I would carry out in order to ensure that the control was operating properly will include:

- Attending one of the sessions when mail is being opened to observe that the exercise is conducted by two persons;
- Inspecting the listing of the receipts to confirm that it is accurately prepared and all the receipts for the day are recorded;
- Inquiring from officials of the client that the opening of the mail is always conducted by two persons and inspecting a sample of the listings prepared

during the year to confirm that there is evidence that the mail opening was indeed conducted by two persons.

b) The purpose of requiring that a fixed assets register must be maintained and promptly updated:

A fixed assets register provides details of all the assets of the company, the location, serial identification number, person who has custody, cost, depreciation policy and the net book value among other details. This register serves the following purposes:

- Ensures that there proper records showing all the purchases and disposals of fixed assets i.e. all the movements in the fixed assets are accounted for;
- Makes it easy to physically verify the existence of the assets. By using the register one can be able to trace the location of the assets;
- Increases accountability over the usage of the assets because all the assets are under assigned specific persons who control their usage;
- Reconciling the fixed assets register to the ledger ensures completeness and accuracy of the fixed assets balances in the ledger.

Tests over the operation of this control

- Inspecting the register to confirm that it is updated with all the assets movements and reconciles to the general ledger;
- Inspecting the register to verify that a senior responsible person reviews the register on a regular basis to ensure completeness and accuracy.

c) The purpose of preparing a bank reconciliation statement on a monthly basis:

- Such a reconciliation is useful in ensuring the completeness and accuracy of the bank balance as appearing in the ledger. By reconciling the cash book balance to the bank statement transactions that have not been captured in the cash book such as interest charged/earned will be highlighted and subsequently recorded. In addition any errors made in recording transactions in the ledger will also be identified and corrected.
- Such a reconciliation will highlight any fictitious transactions that have gone through the bank for example fraudulent payments which have not been captured in the cash book will be identified;
- The reconciliation will also highlight any errors that might have been made by the bank such as debiting the accounting with a larger amount than was paid out. Such errors can then be followed up with the bank.

Testing the operation of this control

- I will inquire whether the reconciliation‘s are indeed prepared on a monthly basis;
- Inspect a sample of the reconciliation‘s and confirm that they are indeed prepared on a monthly basis and that there if evidence of review by a senior responsible person;
- Inspect a sample of the reconciliation‘s to confirm that they are accurately prepared, the reconciling items are promptly cleared and that there are no unexplained variances.

QUESTION THREE

a) You are required to write brief notes on the following

i) Inspection

This consists of examining records, documents or tangible assets. The reliability of the evidence obtained from inspection of records and documents depends on the nature, source and effectiveness of the internal control system. Inspection of tangible assets provides evidence with respect to their existence but not as to their value and ownership.

ii) Observation

This involves looking at procedures being performed by others. E.g. observing the counting of stock by the client's personnel.

iii) Inquiry

Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. This ranges from formal written inquiries addressed to 3rd parties to oral inquiries addressed to persons within the entity. The information may be new to the auditor or may corroborate evidence from other sources.

b) You are required to define the term audit programme

Audit programs describe how the audit approach is to be implemented. Auditors develop an audit program for each material account balance or account balance assertion. An audit program describes what and how much evidence is required to be gathered and evaluated, and how, when and by whom it is to be gathered and evaluated during the interim and final visits. In other words, an audit program details the nature,timing and extentofthe planned audit procedures relating to a particular accountbalance or account balance assertion.

c) You are required to write an audit programme to cover salary and wages of a small size firm

Audit Programme over salaries and wages

Client	XYX Company Limited
Financial period	Year ended 31 December 2003
Accounting area	Salaries and wages
Prepared by	David Mwindi
Reviewed by	Joseph Kamau

Audit Objective

To obtain sufficient appropriate audit evidence that:
- Completeness
- Existences
- Accuracy

Of salaries and wages is not significantly misstated

Audit Procedure	**Work paper reference**	**Reviewed by and date**
Tests of controls ▪ Verify that the payroll is reviewed and authorised by a senior responsible official before the salaries are paid; ▪ Confirm that the computation of wages is carried out by an independent person ▪ Confirm that a review of new employees who have joined the company and leavers is carried out before wages and salaries are paid; ▪ Confirm that a month-to-month reconciliation is prepared and changes in wages and salaries from one month to the next investigated.		

Substantive procedures **Analytical review** ■ Compare the current years wages and salaries to the previous year and obtain explanations for any significant movements noted; ■ For salaries perform a reasonableness test by taking the previous year's audited salaries expense. Adjust this for any salary adjustments and for new employees and leavers. Compare the expected salary expense to the actual charge as per the client's ledger and obtain explanations for any significant variances; ■ For wages obtain the month on month average number of employees and the average rate of pay per day. Using this data recomputed the expected wages expense and compare this with the actual amount as per client's ledger. Obtain explanations for any significant variances. **Tests of details** ■ Obtain a sample of employees and compare the salary as per the payroll to the employment contract;		

QUESTION FOUR

a) The following factors influence the auditor in determining the size of the sample for his detailed testing.

- The tolerable error or deviation rate- the larger the tolerable error or deviation rate, the smaller the sample size.
- Auditor's assessment of inherent risk. The higher the auditor's assessment of inherent risk, the larger the sample size. Higher inherent risk implies that there is a greater risk that the financial balance will be misstated. To reduce this risk the auditor will need to extend the level of testing. This is achieved by testing a larger sample.
- Auditor's assessment of control risk. The higher the auditor's assessment of control risk, the larger the sample size. A high control risk implies that little reliance can be placed on effective operation of internal controls. To reduce the audit risk the auditor will need to extend the level of testing, this is achieved by increasing the size of the sample.
- Expected error. This refers to the total error that the auditor expects to find in the population. The greater the amount of error the auditor expects to find in the population, the larger the size of the sample needed in order to make a reasonable estimate of the actual amount of error in the population.
- Auditor's required confidence level. The greater the degree of confidence that the auditor requires that the results of the sample are in fact representative of the actual amount of error in the population, the larger the sample needs to be.

b) Three areas where judgement is exercised by the auditor in using statistical sampling

Although statistical sampling applies probability theory in making sampling decisions it is not possible to eliminate the need to apply judgement in certain stages of the sampling process. These include:

(I) In planning the sample the auditor will need to apply his judgement in identifying the most appropriate population from which the sample will be selected. This is because after determining the audit objective, the auditor will need to identify the most appropriate population that will be tested to meet the audit objective. E.g. if the audit objective is to test debtors for recoverability the most appropriate population will be an aged debtors listing. The selection of this will require the use of judgement.

(II) Assessment of the tolerable risk, inherent risk, deviation risk and control risk requires the use of judgement. These factors are relevant in determining the appropriate size of the sample.

(III) Judgement is required in evaluating the effect of the results obtained after testing the sample units and also in concluding whether the audit objectives have been achieved.

QUESTION FIVE

a) Stock take instruction are issued to the staff undertaking the stock take to brief them on the procedures to be followed during the count. Definite instructions preferably in writing should be issued in all cases for the guidance of those who will be engaged in the actual stock taking. The instructions should contain:

a. The method of identification of the stock items and their ownership;
b. Counting, weighing or measuring.
c. Reporting of stocks which are damaged/defective.
d. The following issues should be addressed:

- Stocktaking should be well planned and carried out systematically by persons who are fully informed of the duties involved;
- These persons should be familiar with the stock but supervisors should be from different departments;
- Counting should be done by at least two people, one to count and the other to check and record what has been counted;
- Stocks should be marked to facilitate counting and avoid double counting;
- The whole stock taking area should be divided into sections for control purposes and avoids double counting.
- Ensure that properly qualified personnel are available where specialised knowledge is necessary to identify, quality and quantity of stock.
- Cut off procedures should be performed i.e. dispatch documents for all goods belonging to customers and still held by client and those that have already passed to the customer. Such stock should be excluded from the stock take.
- Goods held in safe custody for others should not be recorded as part of the client's stock.
- Arrangements to confirm the goods held for the company by outside parties should be made.
- There should be procedures to identify the slow moving and obsolete/damaged stock.
- There should be procedures for identification of the stage of completion of work in progress.

b) Work to be performed and matters to consider during the count

The main task is to ascertain whether the client's employees are carrying out their instructions properly so as to provide reasonable assurance that the stock take was accurate and not necessarily to count stock. This will be achieved by observing the way the count is conducted and also carrying out sample counts. When carrying out the sample counts the auditor should pick items from the shelves count these and compare the results with what was obtained by the count team. The following procedures should be carried out:

- He should make notes for follow up purposes of items counted in his presence, details of damaged, obsolete or slow moving items.
- He should find out the methods of identifying slow moving obsolete or damaged stock.
- Record fully the work done and his impression of the stock take exercise.
- He must form a conclusion as to whether the stock take can be relied on.
- Get photocopies of rough stock sheets.
- Get details of the sequence of the stock sheets.
- Pay special attention to high value items during his sample tests;
- If the auditor is not satisfied about the way stock taking was conducted he should inform management and may request a recount.

Note that

The auditor should conclude whether stock taking was properly carried out and can be relied upon for determining the existence of stock. He should also try to gain from his observations an overall impression of the levels and values of stocks held so as he may judge whether the value of stocks appearing in the financial statements is reasonable.

QUESTION SIX

a) You are required to explain the controls that can be established over completeness of input

Controls over completeness of input seek to ensure that all input data is captured by the system for processing

- Use of batch totals where by the total input data processed is compared with the original batch totals;
- Use of document count edit control to verify where transactions are supported by pre-numbered documents that all the transactions are recorded by reference to the documents utilised.
- By investigating any data rejections to ensure that the reasons are established and where necessary the data resubmitted for processing;
- Manual comparison of input data to output to ensure that all transactions have been recorded;
- Use of hash totals. A hash total is a control total without a defined meaning, such as the total of employee numbers or invoice numbers, that is used to verify the completeness of data. Thus the hash total for the employee listing by the personnel department could be compared with the total generated during the payroll run;
- Use of record count edit control. This is a control total of the number of records processed during the operation of a program.

b) Controls over validity

These controls seek to ensure that only valid transactions are processed. The controls that management can put in place include:

- Validity checks in the hardware. This consists of the hardware that transmits or receives data comparing the bits in each byte to the permissible combinations in order to determine whether they constitute a valid structure;

- Reasonableness tests which check the logical correctness of relationships among the values of data items on an input and the corresponding master file record. For example if employees work only for eight hours, a reasonableness test could be performed to determine that no employee is credited with more than eight working hours. Such control will check for the validity of the input data;
- Validity checks- these are tests of identification numbers or transaction codes for validity by comparison with items already known to be correct or authorised. For example KRA PIN numbers can be compared with the PIN numbers in the personnel records

c) The most common input controls are edit controls. Examples of edit controls include;

Type of edit control	Description of control	Objective
Missing field check	Checks that all essential data fields are present and are of the right length	Ensures accuracy of the processed data. Transactions cannot be properly processed if necessary data is missing
Valid character check	Checks that data fields appear to be of the right type e.g. all alphabetic, all numerical or mixed.	Ensures correctness of input data
Limit/reasonableness checks	Checks that data falls within predetermined reasonability limits e.g. hours worked do not exceed a certain limit, maybe 8 hours a day.	Ensures accuracy and validity of input data
Master file checks	Checks that all codes match those on master files e.g. employee's number matches an employee number on the personnel file.	Ensures that data is processed against the correct master file.
Check digit	Applies an arithmetic operation to the code number and compares the result to the check digit	To ensure accuracy of data by checking keystroke errors.
Document count	Agrees the number of input records in a batch with the total on the batch control form	Ensures that all documents are input

QUESTION SEVEN

a) An expert or a specialist is a person possessing specialised skills, knowledge and experience in another field other than auditing and accounting. From his training and experience an auditor only has general knowledge on matters outside his profession and he is not expected to have the shills of a person trained or qualified to work in another profession. Consequently the auditor may need advice of other experts e.g. lawyers in arriving at the legal interpretation of legal cases against a client

Situations Where The Auditor May Require Advice of an Expert

- Legal interpretation of contracts, laws and regulations
- Valuation of certain types of assets e.g. land and buildings, precious stones and minerals.
- In determining quantities and physical condition of assets e.g. underground minerals/quarries.
- Actuarial valuations;
- Measurement of work completed/to be completed in contracts.

To be able to reach on objective conclusion on the financial effect of some of the transactions and events that have taken place the auditor may require the opinion of an expert. Such an opinion or report will enhance the auditors' knowledge of the situation at hand and will therefore be able to conclude whether the financial effect of the issues have been properly dealt with in the financial statements

b) The extent to which the specialist should be independent

The auditor should evaluate the independence of the expert before relying on his work. If the expert is not independent of the client then there is a risk that the opinion given by the expert could be in the favour of the client. The auditor should therefore be on the look out for any factors that could impair the specialist's independence.

The risk of independence being impaired increases where the expert is employed by the client; in such cases he owes his loyalty to the client, or where he is related financially with the client.

c) The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial statements. The auditor should consider;

The skills and competence of the expert. The auditor should consider the expert's skills and competence in the particular profession. This is done by considering the expert's professional qualifications, license or membership of an appropriate professional body. The experience and reputation in the field in which the auditor is seeking evidence.

QUESTION EIGHT

a) You are required to discuss the significance of the date of the auditor's report in the context of subsequent events

The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require disclosure in the financial statements have been identified. The auditor's responsibility extends to the date on which he signs his report and he must obtain reasonable assurance that the effect of all material subsequent events are either disclosed or accounted for in the financial statements. The date of the auditor's report is therefore important because it determines the period where the auditor is responsible to perform audit procedures in respect of post balance sheet events.

After the date of the auditor's report the directors are responsible for informing the auditor of any post balance sheet events that may require to be considered.

b) The audit procedures considered necessary between the balance sheet date and the date of the auditor"s report

- Reviewing procedures management has established to ensure that subsequent events are identified and inquiring whether any such events have occurred which might affect the financial statements being reported on;
- Reading minutes of the meetings of the board of directors and audit committees held after the end of the financial period. By reading such minutes the auditor is able to identify any material subsequent events that might have occurred since this would ordinarily be discussed at these meetings;
- Review the entity's latest available interim financial statements and other reports such as budgets, cash flow forecasts. By reading such interim financial statements the auditor is able to identify any subsequent events;
- Inquiring from the entity's lawyers on litigation and legal claims against the company. This will provide further details on any developments on such litigations;
- Inquiring from management whether any subsequent events have occurred which might affect the financial statements.

When the auditor becomes aware of events, which materially affect the financial statements, he should consider whether such events are properly accounted for in the financial statements.

c) **Auditors actions regarding events after the date of the audit report**

The auditor does not have any responsibility to perform procedures or make any inquiry regarding the financial statements after he has issued his audit report.

During this period from the date of the auditor's report to the date when financial statements are issued to the directors of the company, the responsibility to inform the auditor of facts, which may affect the financial statements, rests with management.

When after the date of the of the auditor's report but before the financial statements are issued to the shareholders, the auditor becomes aware of facts which may materially affect the financial statements, the auditor should consider whether the financial statements need to be amended. He should then discuss the matter with management and should take appropriate action depending on the circumstances.

If management amends the financial statements to reflect the effect of the subsequent event, the auditor should carry out the necessary procedures and report on the amended financial statements.

When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and the auditor's report has not been released to the entity, the auditor should amend his report and express a qualified opinion or adverse opinion as appropriate.

Where the auditor's report has been released to the entity he should notify the directors not to issue the financial statements and the auditor's report to the shareholders and other third parties. If the financial statements are subsequently released, the auditor should take action to prevent reliance on the auditor's report.

Facts discovered after the financial statements have been issued to shareholders

After the financial statements have been issued, the auditor has no obligation to make any inquiry regarding the financial statements. However, if it becomes aware of facts which existed at the date of the auditor's report and which if known, at that date, may have caused the auditor to modify his report, the auditor should consider whether the financial statements need to e revised, should discuss the matter with managements and should take action appropriate in the circumstances.

When management revises the financial statements, the auditor should carry out the audit procedures necessary in the circumstances, should review the steps taken by management to ensure that any one in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation and would issue a new report on the revised financial statements. The auditor's report should include an emphasis of matter paragraph referring to a note in the financial statements and to the earlier report issued by the auditor.

MAY 2009

QUESTION ONE

(a) A flow chart is a diagrammatical representation of an accounting system. Use of flow charts has the following advantages: -

- Easy to prepare
- Since the information is presented in a standard form, flow charts are easy to follow and review.
- They generally ensure that the system is recorded in full, all the documents have to be traced from beginning to the end.
- They eliminate the need for lengthy narratives and can be very effective in highlighting the salient features of internal controls and any weaknesses in the system.

(b) The main difference is that an internal control questionnaire (ICQ) is used to determine whether controls exist which meet specific control objectives whereas an internal control evaluation questionnaire (ICEQ) is used to establish whether specific errors or frauds could occur rather than establishing whether certain desirable controls are present. Only few key control questions are used concentrating on the significant errors or omissions that could occur at each phase of a transaction cycle.

(c) Is there reasonable assurance that: -

(i) Employees are only paid for work done?
(ii) Employees are paid the correct amount (gross and net)?
(iii) The right employees actually receive the right amount?
(iv) Accounting for payroll costs and deductions is accurate?
(v) Employees paid are bonafide employees of the organization and not ghost workers?
(vi) Payroll deductions are not misappropriated.

(d) According to the ISA glossary on definition of terms, the following terms are defined as:-

(i) Tests of Control: - These are tests performed to obtain audit evidence about the effectiveness of the: -

a. Design of the accounting and internal control systems that is, whether they are suitably designed to prevent or detect and correct material misstatements.
b. Operation of the internal controls throughout the period.

Tests of controls therefore aim at determining whether the identified controls have operated effectively as designed throughout the financial period and can be relied upon to reduce the extent of substantive testing.

(ii) Substantive procedures refer to tests performed to test the management assertions made in the preparation of financial statements. They are of two types: -

a. Tests of detail of transactions and balances
b. Analytical procedures

These procedures seek to provide audit evidence as to financial statement assertions such as completeness, existence, valuations, occurrence, measurement, rights and obligations and presentation and disclosure.

QUESTION TWO

a) Audit evidence refers to the information obtained by the auditor in arriving at the conclusions on which the audit opinion on the financial statements is based.

Audit evidence comprises source documents and accounting records underlying the financial statements and corroborating information from other sources. For example a confirmation from the bank on the client‘s bank balance is evidence that the auditor could use in verifying the existence of the bank balance.

Audit evidence is obtained by carrying out both compliance and substantive procedures.

b) Relevance of audit evidence

- Relevance refers to the ability of the evidence to assist the auditor in testing management‘s assertions or to test the audit objective;
- Relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statements. To achieve this objective the auditor needs to obtain evidence to enable him to draw reasonable conclusions on various management assertions made in preparing the financial statements.

Reliability of audit evidence

The reliability of audit evidence refers to the credibility of the evidence.

This credibility is influenced by its source; whether from internal sources or external sources and by its nature; whether visual, documentary or oral. Reliability of the evidence depends on individual circumstances but we can make the following generalizations:

- Audit evidence from external sources e.g. a third party (e.g. a debtor) confirming amount owing to the company is more reliable than evidence generated internally;
- Audit evidence generated internally e.g. from accounting records is more reliable when the related accounting and internal controls are effective;
- Evidence obtained by the auditor himself is more reliable than that obtained from the entity;
- Evidence in the form of documents and written representations is more reliable than oral representations.

Sufficiency of audit evidence

- Sufficiency is the measure of the quantity of audit evidence;
- Sufficiency is therefore the question of how much information is needed to be able to conclude on the financial statements.

(c) Procedures of obtaining audit evidence:-

i) Inspection:- This is the physical review of examination of records, documents and tangible assets. An example of a test of control is examining sales invoices for authorization: An example of a substantive procedure would be to check the physical existence of a tangible asset. Additional work may be required to determine ownership, valuation and contractual obligations.

ii) Observation:- This involves looking at a process or procedure being performed. An example is the distribution of wage packets to see that internal control procedures are adhered to or the observation by auditors of stock being counted in accordance with stock taking instructions.

iii) Enquiry and confirmation: - Seeking relevant information from knowledgeable persons inside or outside the enterprise, whether formally or informally, orally or in writing. The reliability of this technique depends on the qualification and integrity of the source. An example is the seeking of formal representations from management on the value of a material subsidiary company in an overseas country or the circularization of debtors for independent verification of year-end balances.

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ii) Computation: - This involves checking the arithmetical accuracy of records or performing independent calculations e.g. recomputing the depreciation charge and comparing with the client's figure.

iii) Analytical review- Analytical review can be defined as the study of relationships between element of financial information expected to conform to a predictable pattern based on the organization's experience and between financial information and non-financial information.

Analytical procedures concern not only analysis (of ratios, trends and relationships) but also the investigation of fluctuations. The analysis usually considers both comparisons and relationships.

For example the auditor can compute the debtors days ratio for the current year and compare this with the previous year. This will provide valuation information in evaluating whether customers are settling their accounts when due and if there is need to create a provision for doubtful accounts.

QUESTION THREE

a) Internal audit is an appraisal or monitoring activity established by management for the review of accounting and internal control systems as a service to the entity. It examines, evaluates and reports to management on the adequacy and effectiveness of the systems.

Other activities include:-

a) Review of the accounting and internal control systems. Management is responsible for establishing an internal control system. These systems demand proper attention and continuous review, a function that is usually assigned to internal audit. The internal audit function designs a work plan that shows the areas and control procedures that will be reviewed during the year.
b) Carrying out examination of financial and operating information. This may include detailed testing of transactions and accounting and operating procedures.
c) Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
d) Review of the entity's compliance with laws and regulations. The internal audit function reviews whether the company has put in place appropriate procedures to ensure that all the relevant laws and regulations are adhered to. This will include review of adherence to laws such as taxation legislation, stock exchange listing regulations among others.
e) Review of the entity's compliance with management policies and other internal requirements
f) Carrying out independent investigations into the affairs of the company as required by management. The internal audit function will carry out investigations e.g. where frauds are suspected, where there is suspected inefficiency in the use of the company resources e.t.c

b) Before deciding whether to rely on the work of the internal audit function with the intention of reducing audit procedures the external auditor should evaluate the internal audit function to determine the scope of the function, its independence and hence how much reliance can be placed on the work that it carries out. The external auditor can only rely on the work of the internal auditor as one element of the internal control system.

In evaluating this function the external auditor should consider the following factors:

1. Organization status

Since internal audit function is part of the entity it cannot be totally independent. To boost it's independence the status of the function within the organization should be such that the internal auditor reports to the highest level of management. The internal auditor should also be free of any other operating responsibility such as performing accounting functions, which may conflict with his role as an independent watchdog of controls and operations of the entity. There should be no restrictions placed upon his work by management. Such restrictions could impair the effectiveness of the function.

2. Scope of the function

The external auditor should ascertain the nature and depth of coverage of internal audit assignments. He should also ascertain whether management considers and acts upon internal audit recommendations. Where the recommendations are not acted upon this represents a weakness in the function and hence the level of reliance should consequently be reduced.

3. Technical competence

The external auditor should ascertain whether internal audit work is performed by persons having adequate technical training and proficiency as auditors. Qualifications and experience of the internal audit staff should be considered.

c) Due professional care

The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. Exercise of due professional care is evidenced by the existence of adequate audit manuals, work programs and working papers.

d) Internal audit reports

The external auditor should consider the quality of the internal audit reports prepared and submitted for management action. He should ascertain whether management considers, responds to and acts upon internal audit reports and whether there is evidence to prove that action.

e) Level of resources available

The external auditor should consider whether internal audit has adequate resources to be able to carry out their duties effectively. Such resources would include staff and computer facilities.

c) When an auditor decides that he can place reliance on the internal auditors work, the extent of his reliance will be influenced by the results of his evaluation of the internal auditors work.

This evaluation will involve:-

(i) Discussion with the clients internal auditor about the timing of internal work, test levels, sample selection and the form of documentation to be used.

(ii) Consideration of:-

a. The materiality of the items or areas to be tested, and also of the information that can be obtained from internal audit.
b. The level of audit risk inherent in the areas or items to be tested or in the information to be obtained.
c. The level of judgment required
d. The sufficiency of complementary audit evidence
e. Specialist skills possessed by internal audit staff

(iii) Setting out the extent of planned reliance on internal audit, together with reasons for deciding on that extent, in a planned memorandum.

(iv) Review of the manner in which the internal audit work is being controlled particularly:-

a) Consider whether work has been properly supervised and also reviewed in detail when it has been completed.
b) Compare the results of the work with those of external auditors staff on similar audit areas or items
c) Satisfy himself that any exceptions or unusual matters that have to come to light as a result of the work have been properly resolved.
d) Examine reports relating to the work produced by internal audit and management‘s response to those reports.
e) From time to time, determine whether internal audit will be able to complete the program that it has agreed to undertake and if not make appropriate arrangements.

(v) Ensuring that the working papers relating to the work of internal audit, on which reliance is being placed, are up to an acceptable standard.

Conclusion: Since the internal auditor cannot meet the prime criteria of independence, the external auditor cannot fully rely on the work of the internal auditor. The extent of reliance will be determined by applying judgement.

QUESTION FOUR

a) (i) Statutory audit

This is an audit carried out as per the requirements of the Company‘s Act for limited companies be they private or public. The Company‘s Act, Cap 486 requires that all limited companies submit their returns at the end of the financial period to the registrar of companies and that these returns should include the audit report. In these audits, the auditors appointment is as per Section 159 (1) – (6) of the Company‘s Act. His rights and duties are defined in Section 162 (1) – (12). This Act opens up the auditors scope, rights and duties and extensions of his liabilities which cannot be limited by any powers be they the shareholders or Board of Directors.

During such audits the auditor is free to obtain all the information and explanations he considers necessary for the purpose of forming an opinion.

(ii) Private audit also known as non-statutory audit.

These are audits conducted for private institutions, which are not required by any statutes to have their financial statements audited. The audits are not mandatory but are carried out for the convenience of such organizations.

By virtue of its nature the auditor‘s scope, rights and duties are defined by an agreement between the auditors and owners or agents of the company. The auditor‘s obligations are contractual since they are based on an agreement between the auditor and his clients.

This agreement is crucial as it forms the basis for defining the auditor‘s duties, rights and obligations. Thus the auditor should ensure that the agreement between him and the client clearly defines his scope.

In such audits, the auditors rights and scope may be limited and due to such limitations the auditors opinion will usually contain a disclaimer clause.

(iii) Balance Sheet audit

These are audits in which the auditor starts his audit work from the balance sheet and traces entries to their original posting in a bid to prove their authenticity. This audit concentrates on balance sheet entries and falls under partial audits as the auditor will not check all entries but will rely on evidence obtained on balance sheet entries to form conclusions as to whether all other entries are authentic. For this reason, this audit is only appropriate for organizations which have a strong internal control system or when conducting a special audit assignment where the client requires the auditor to only report on the balance sheet items.

(iv) Management audit

These involve the investigation of the company‘s entire management to ascertain their decision making process, especially of the top management and their attitude towards the operation of the internal control system, personal relationships with employees and their ability to manage an efficient and viable company.

It is ideal: -

a. Where there are dynamic operations in an organization.
b. For company‘s using high technology

b) Advantages of an audit

1. It provides assurance and credibility to the accounts in the audit report.
2. Disputes between management may be more easily settled. E.g. a partnership which has complicated profit sharing arrangements may require an independent examination of those accounts to ensure as far as possible an accurate assessment and division of those profits
3. Major changes in ownership may be facilitated if past accounts contain an unqualified audit report. For instance, where two sole traders merge their business to form a new partnership.
4. Applications to third parties for finance may be enhanced by audited accounts due to the credibility created by having the financial statements audited.
5. The audit is likely to involve an in-depth examination of the business and so may enable the auditor to give more constructive advice to management on improving the efficiency of the business.

c) Auditors"Duties - Section 161

c) To report to the members on each set of accounts laid before the company in the general meeting, whether in his opinion.

The balance sheet gives a true and fair view of the state affairs of the company as at the balance sheet date.

The profit and loss gives a true and fair view of the profit (or loss) for the period ended on that date.

c) The accounts comply with the requirements of the company's Act.

2. Duty to state the following in his report.
   a) Whether the auditor has received all the information and explanations which in his opinion was necessary for his audit.
   b) Whether he received adequate returns from branches not visited by the auditor during the audit.
   c) Whether in his opinion proper accounting records have been maintained.
   d) Whether the accounts are in agreement with the underlying records.
3. Duty to provide working papers.

   An auditor has a duty to assist investigators in to the company's affairs by providing his working papers, which are summaries of significant matters identified by the auditor during the course of the audit.
4. Duty to certify the Profit and Loss account and Balance Sheet in a prospectus. A prospectus is the publication prepared by the company that is intending to sell shares to the public.
5. To include in his report any required information about the directors' remuneration,which has been omitted from the accounts.
6. To consider if any information in the directors report is inconsistent with the accounts and to report the facts if there are any such instances.

QUESTION FIVE

a) Control procedures are those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Control procedures include the following:

- Preparation and review of reconciliation's;
- Checking the arithmetical accuracy of the records;
- Having proper segregation of duties;
- Physical controls to safeguard the assets of the company;
- Controlling applications & environment of computer information systems e.g. by establishing controls over:
  - Changes to computer programs.
  - Access to data files.
- Approving and controlling the use of documents.
- Limiting direct physical access to assets and records.

b) Internal check is an element of the internal control system which ensures that the activities of an individual in the organization or entity, is automatically, checked by another individual.

Internal check is boosted by the segregation of duties such that no person can carry out a transaction from initiation to conclusion without his work coming under the check of another person.

Internal checks can also be defined as: ―The checks on the day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the objective being the prevention or early detection of errors and fraud‖.

c) A vouching audit is also known as a substantive audit.

This audit approach involves checking the authenticity of recorded transactions by inspecting the document(s) used in processing of the transaction. It is proving that the transactions occurred, they are complete, correctly measured and they relate to the correct period if they are of a revenue or expense nature.

d) A walk-through refers to the auditor selecting a particular transaction and tracing (or walking) it through the accounting information system from the time it was first captured and input as data to its final disposition in the financial statements. The purpose of the walk-through may be either for the auditor to identify specific control procedures or to confirm an existing understanding of control procedures in the accounting information system. The walk-through may be the tracing of an event, either part way through the system or entirely through the system, depending on the extent of the evidence or knowledge required by the auditor.

e) Weakness tests.

These are tests carried out to areas of weakness in the internal control system. The objective is to identify weak controls where corrective action should be taken to enhance the internal control system.

QUESTION SIX

a) In order to test the vouchers for errors, I would;

i. Cast the figures in the vouchers in order to determine their arithmetical accuracy.
ii. Compare the current year's payments against the previous year's and investigate any unfavourable variance or difference.
iii. I would trace the payment vouchers to the ledger accounts to ensure no payment was left out in the vouching.
iv. I would inspect the payment voucher for authorization by the responsible official. I would expect authorization to be evidenced by a signature or stamp.
v. I would inspect the documents underlying the payment voucher such as the goods received note.
vi. I would carry out a sequence check on the payment voucher to establish the completeness of the vouchers. Any cancelled or spoilt vouchers should be accounted for.

b) It is not satisfactory to pick vouchers from a limited period as these vouchers may not be representative of all the vouchers that were raised in that period.

This is because these vouchers may relate to payments that are subjected to special conditions or conditions that were not prevalent in the company throughout the period, e.g. there could have been a different accountant recording the payments made via those vouchers different people giving authority etc.

c) Statistical sampling is ideal in the following conditions:-

i) The population to be tested must be homogenous i.e. it must consist of items of the same kind, subject to the same level of audit risk.
ii) The population must be fairly large, otherwise the benefits of the technique will not be achieved. Statistical techniques need to be adjusted to work on small populations.
iii) Expectation of error must be low – i.e. control risk must have already been assessed as less than high (i.e. ICS is strong). High control risk requires impractically large sample sizes.
iv) The items in the population must be easily identifiable once selected so that checking of the items is easily carried out e.g. Items such as invoices must be pre-numbered and filed in sequence.

QUESTION SEVEN

a) **General controls**

These are controls, which relate to the environment within which computer-based accounting systems are developed, maintained and operated aimed at providing reasonable assurance that the overall objectives of internal controls are achieved. These controls could either be manual or programmed.

The objectives of general controls are to ensure proper development and implementation of applications and the integrity of program and data files and of computer operations. General controls will include:

a) Systems development controls
b) Organisational controls.
c) Access controls
d) Other controls

Application controls

The objectives of application controls which may be manual or programmed are to ensure the completeness and accuracy of the accounting records and the validity of the entries made therein resulting from both manual and programmed processing. These relate to the transactions and standing data pertaining to each computer based accounting system and are therefore specific to each such application. With the increasing sophistication of computer operating systems it is becoming more common for controls to be programmed as part of each application. Application controls are generally divided into:

a) Input controls.
b) Processing controls.
c) Output controls.
d) Controls over master files and standing data.
e) Controls over standing data and master files

b) **Controls to prevent unauthorised changes to data files**

- Only specific employees should be granted powers to amend data on computer files. These should be senior officials.
- The computer system should maintain a log of all amendments to data files, date amended and the person who carried out the amendment. Such a log would assist in subsequent follow up and investigation of any unauthorised amendments.
- Employees should be encouraged not to leave their computers unattended once they have logged in. people should be encouraged to log out whenever they are not using their terminals.
- Data files that are off line should be stored securely and access restricted
- Data files containing important data should be on read only memory;
- Users should be granted different levels of user rights such that only specified users can make amendments to data files.

c) **Why the company should carry out parallel running of the two systems**

Parallel running refers to the running of the existing system and the new system concurrently for a period of time before switching to the new account. This is carried out for the following reasons:

- It enables the programmers and the users to review the system, prior to authorisation for full implementation;
- Implementing smooth personal changes and avoiding the problem that key employees might take with them all the knowledge on how the system works.

- Parallel running assists in training the staff on how to operate the system while still having the old system to refer to;
- It helps in testing the system to ensure that the system is fully operational before putting it into full use.

QUESTION EIGHT

a) According to ISA 210, the principal contents of an engagement letter include reference to:-

a) The objective of the audit of financial statements.
b) Managements responsibility for the financial statements
c) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
d) The form of any reports or other communication of results of the engagement.
e) The fact that because of the test nature and other inherent limitations of an audit together with the inherent limitations of any accounting and Internal Control System, there is an unavoidable risk that even some material misstatement may remain undiscovered.
f) Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

The auditor may also wish to include in the letter:

- Arrangement regarding the planning of the audit
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter
- Description of any other letters or reports the auditor expects to issue to the client
- Basis on which fees are computed and any billing arrangement.

When relevant the following points could also be made:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other client staff
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the client.

The appendix to ISA 210, contains an example of an engagement letter and it is reproduced below:-

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the balance sheet of ……. as of ………….. and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be made with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which come to our notice.

We remind you that the responsibility for the preparation of financial statements including adequate disclosure is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the company. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ &Co.

Acknowledged on behalf of
ABC Company by

(signed)
……………..
Name and
Title Date

(b) The engagement letter serves the following purpose:-

i) The letter defines the scope of work to be carried out and the respective responsibilities of the auditor and the client under the engagement. This helps in avoiding misunderstandings between the client and the auditor as regards to the scope of the work to be carried out and the respective responsibilities of both parties.

ii) The letter documents and confirms the auditor‘s acceptance of the appointment

iii) It explains the forms of any reports to be issued under the engagement

iv) To educate the client on: -

- His duty to maintain proper books of accounts and to prepare financial statements that show a true and fair view.
- His duty to prevent errors and frauds.
- His duty to provide all the necessary information
- That the audit should not be relied upon to detect errors and frauds.
- To explain that the audit will be carried out on a test basis.
- Basis of charging his fees.

v) Minimise auditor‛s liability to third parties. The auditor may include a clause in the engagement letter limiting the client from distributing the audit report to parties other than those agreed on an identified in the engagement letter.

DECEMBER 2009

QUESTION ONE

(a) The steps I would take after appointment at the AGM include: -

1) I would obtain instructions from the client as to the scope of the work and whether this is in addition to what is assigned to me by the Company's Act in which case it should be put or referred to in a letter of engagement.
2) Considered whether my appointment was legally carried out as per the requirements of the company's Act. In particular I would obtain a copy of the resolution passed at the AGM appointing my firm as the auditors of the company.
3) I would issue a letter of engagement to the client. This letter would serve the purpose of defining the scope of my audit work and as a formal acceptance of the audit work.
4) I would seek for background information about the client. This would include the nature of its business, the owners of the company and its financial information. Such information will assist in evaluating the potential risk in associating with the client and also in planning the approach to be adopted in carrying out the work.

b) A preliminary review is important as it helps the audit firm to screen out potentially risky audit clients and also identify any factors that could affect the nature of the work to be performed and also the approach to be adopted by the auditor.

The considerations which are relevant in deciding whether a client is a high risk include:-

- evidence of client engagement in fraudulent or illegal activities
- the state of the economic sector in which the client operates (a depressed sector may indicate risk)
- the nature of the industry and the clients product lines
- the clients previous audit history (frequent changes of auditors, and/or qualified reports are indicators of high risk clients)
- The general abilities of the client management
- Understanding of the directors of their own role and that of the auditor
- Evidence of management intentionally failing to record a material transaction.

(c) It is important for an auditor to hold discussions with the clients senior staff in order to:-

1) Agree on the terms of engagement which clearly state and specify the scope of the audit.
2) Determine any changes that have taken place in the client entity such as:-
   - changes in accounting policies used
   - changes in senior management
   - changes in product lines.
3) To ensure management clearly understand their responsibilities especially in regards to preparing financial statements that show a true and fair view.
4) To obtain as much information as possible about the client e.g, the current trading circumstances the reliability of the accounting and internal control system which will help the auditor in formulating an appropriate approach for the conduct of the audit.

(d) It is important for an incoming auditor to hold consultations with the outgoing auditor because: -

i) It is a matter of professional courtesy

ii) To enable him to obtain all the pertinent matters relevant to the audit from the outgoing auditors. This includes issues which would influence his decision as to whether or not to accept the appointment. The outgoing auditor will be able to provide information such as the reasons behind their removal as auditors of the company. Scuh information will be useful in deciding whether to accept the appointment or to decline.

QUESTION TWO

(a) The main reason why an external audit is carried out for companies registered under the Company's Act is to fulfill statutory requirements. The Company's Act requires that every limited company shall within nine months after the end of its financial period hold a general meeting where audited financial statements shall be laid out before its members.

Other reasons why an audit may be carried out **(advantages of an audit notnecessarily for limited companies)** include: -

1. To provide assurance and credibility to the accounts in the audit report which is crucial to all parties who have an interest in the company.
2. Third parties who do not take an active role in the running of the business are protected by the audit. The auditor issues a report as to whether the financial statements show a true and fair view.
3. The audit could assist in the detection and prevention of errors and frauds in the entity.
4. An audit will keep the client's accountants vigilant and up-to-date. This ensures that complete and accurate records are maintained.
5. Audited accounts by independent auditors minimize chances of disputes among partners in a business e.g. in profit and asset sharing
6. In case a new partner wants to join, audited accounts will serve as a basis for such admission to determine how much such a partner has to contribute to existing capital.
7. In case of a retiring or dead partner the audited accounts will serve as a basis of determining what is due to the beneficiaries of the deceased.
8. The audited accounts are used as a basis for borrowing finance from banks and other financial institutions as this will highlight the performance (financial) of the company.
9. Audited accounts are acceptable as a basis of ascertaining tax liability and these are usually accepted by the Income Tax Department for the settlement of income tax for the year.

(b) The Company's Act section 161 covers the circumstances under which one is ineligible for appointment as an auditor section 161(1): A person or firm is not qualified for appointment as an auditor (or in the case of a firm, every partner of the firm) unless he is a holder of a practicing certificate issued pursuant to Section 21 of the Accountants Act 1977. Such a certificate is issued under the following conditions: -

a) A person with CPA (III) qualification

b) A person with at least 3 years post graduate experience in auditing or an accounting environment

c) A person registered with RAB (Registration of Accountants Board)

d) A person registered with KASNEB
e) A person who is a member of ICPA (K.)

Section 161 (2): None of the following persons shall be qualified as an auditor of a company

a) A servant of a company
b) A person who is a partner or is in employment of an officer or servant of a company
c) A body corporate

Section 161 (3): A person cannot be qualified for appointment if he has by virtue of subsection (2) above, been disqualified as an auditor of a body corporate which is that company's subsidiary or holding company or subsidiary of that company's holding company.

(c) Dismissal of an auditor refers to the removal of an auditor, which is dealt with by Section 160 of the Company's Act.

Section 160(1)
A special notice shall be required for resolution at the company's AGM appointing as an auditor another person other than a retiring auditor and providing expressly that a retiring auditor shall not be reappointed.

Section 160 (2)
On receipt of the notice of such intended resolution the company shall forthwith send a copy thereof to the retiring auditor if any.

Section 160 (3)
Where a notice is given as a foresight, the retiring auditor will make with respect to the intending resolutions, representations in writing to the company not exceeding a reasonable length and the company shall send this together with the notice of the annual general meeting to all shareholders of the company and to other parties to whom such notice is sent.

Representations may however, not be sent to shareholders if they are received too late for the company to do so or if it is due to the auditors default.

However, the auditor may read such representations at the AGM (Annual general meeting). These representations need not be read at the AGM if on the application of a member or any other aggrieved party, the court is satisfied that the right confirmed on the auditor by this sub-section is being used to secure needless publicity for a defamatory matter. In addition the court may order the auditor to pay the cost of such a suit either in part or in whole as the case may be.

Appointment of the auditor

This is dealt with by Section 159 of the Company's Act.

Section 159(1): Appointment at the AGM: -

Every company shall, at its AGM appoint an auditor to hold office from the conclusion of that meeting to the conclusion of the next AGM.

Section 159 (2): Automatic reappointment of the auditor

Not withstanding the provisions of sub-section (1) above, a retiring auditor however appointed shall be automatically reappointed without a resolution being passed unless:-

a) He is not qualified for reappointment
b) A resolution has been passed at that meeting appointing someone else or providing expressly that he or she shall not be reappointed.
c) He has given notice in writing of his unwillingness to be reappointed, provided that prior notice is given of the intended resolution to appoint some other person in place of the retiring auditor.

Section 159(3): Appointment by registrar of companies:-

When at an AGM no auditor is appointed or deemed to be reappointed the registrar of companies may appoint an auditor to fill such a vacancy.

Section 159 (5): Appointment of the first auditor:-

As herein provided the first auditors of a company shall be reappointed by the directors anytime before the next AGM and the auditor so appointed shall hold office, up to the conclusion of the next AGM provided that:-

Section 159 (5) (1): The company may at an AGM remove such an auditor and appoint in their place any other person who has been nominated for appointment by any member of the company not less than 28 days before the date of that meeting.

Section 159(5)(2): If the directors of a company fail to exercise their powers then under this subsection the company will at the AGM appoint the first auditor. Therefore the aforesaid powers of the directors shall automatically cease.

Section 159 (6): States: -
The directors may fill any, casual vacancy in the office of the auditor, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act.

(d) Rights and duties of an independent auditor

This stems out from the statutes (Section 162 (1) -(4)) as well as from case law based on decisions made by the courts on auditors duties and rights.

Rights of an auditor

1) Right of access to books of accounts and vouchers of a business at all times. This includes:-

    a. Right of access to statutory books of accounts.
    b. Right of access to returns from branches
    c. Right of access to documents, books and vouchers kept by third parties on behalf of the company.

2. Right to call for information and explanations which the auditor considers necessary for the purpose of forming an opinion. It includes: -

    a. Right to obtain all information from the company‘s books and vouchers.
    b. Right to obtain all information in form of management representations contained in a letter of representation which contains matters for which an auditor could not readily get documentary evidence

c. The right to obtain information from third parties which have had previous dealing with the company

3. Right to receive notices of and attend the general meetings.

4. Right to attend the Annual General Meeting (AGM) regardless of whether accounts are subject to discussion or not this includes:-

   a. Right to read his representation at an AGM if these were received too late for the company to send them to each shareholder to whom notice of the AGM is sent or if the company is in default.

   b. Right to answer questions at the AGM if they have been channelled through the chairman of the AGM.

   c. Right to make presentations or to add to his report any material information which has come to his knowledge after his report has been dispatched but before the AGM. However, an auditor does not have a right to make up for any negligent omission on his Report during an AGM.

5. Right to make a statement at an AGM:-

   a) To correct a wrong impression given to the shareholders by the board of directors.

   b) Right to make a statement on the condition of the company's internal control system, particularly if it has been persistently weak.

6) Right to indemnity:- An auditor has a right to be indemnified out of the company's assets if he has been injured during the course of his audit in so far as such injuries may have occasioned the auditor loss to his name as a professional or to his person as an individual.

7. Right to visit branches: -

   a) Right to information and explanations relating to activities of branches so far as they affect the company's affairs.
   b) Right to examine branch accounts and to request for returns submitted to the headquarters.
   c) Right to communicate and receive information from third parties to such branches.
   d) Right to receive representations from those branches over those matters where the auditor could not have sufficient documentary evidence.

8. Right to remuneration:-
   a) To be paid his fees as and when they fall due.
   b) To have his expenses re-imbursed by the client
   c) To withhold his report until his fees have been paid (right to lien)

9. Right to legal and technical advice.

Duties - Section 161

1. To make a statement or report arising from his examination of books of accounts which is a requirement of the Company's Act and such a report is essential before an AGM can be convened.
2. Duty to state the following in his report:-

a) Whether the auditor has received all information and explanation which to the best of his knowledge is necessary for his audit.

b) Whether the accounts portray the true and fair view of the company's state of affairs and of the company's assets and liability.

c) Whether the auditor has received adequate returns submitted from branches and whether the company has kept proper books of accounts.

3) Duty to prepare working papers i.e. permanent audit file and current audit file. An auditor has a duty to provide working papers to assist investigators on the company's affairs

4) Duty to certify the profit and loss account and the balance sheets in the prospectus where a company issues new shares to the public, such a company must prepare a prospectus that must contain audited financial statements for not less than 5 years preceding the public issue.

QUESTION THREE

a) According to paragraph 13 of ISA 400, ―Risk assessments and internal control‖ the objectives of internal controls is: -

a) To enable management carry out the business in an orderly and efficient manner. Internal controls lay out the various procedures to be followed in conducting the affairs of the organisation. E.g. there will be procedures laying out the procedures to be followed in procuring raw materials to ensure that only necessary materials are procured which meet the quality standards of the company.

b) To ensures adherence to management policies

Management policies vary from the broad objectives to the detailed policy matters necessary to make those objectives realisable. Internal controls also serve a check to ensure that management policies are followed, e.g. if there is a requirement that quotations should be obtained when procuring materials, checks could be carried out to ensure that this is actually being met.

c) To safeguard the company's assets

Some controls are designed specifically to ensure the assets of the company are protected from theft, destruction and that they are used in the best interest of the company.

This can either be directly through physical locking up or indirectly through recording. It includes assessing assets and ensuring that any access is authorised.

d) ICS help in ensuring completeness and accuracy of the records maintained. The company's Act requires that a company keep proper books of accounts. These records are the basis for the preparation of the financial statements.

e) Strong internal controls help in preventing and detecting errors and frauds. The responsibility for the prevention and detection of fraud and error rests with management. This is achieved through the implementation and continuous operation of an adequate system of internal controls. Such a system reduces but does not eliminate the possibility of fraud and error.

b) The disadvantages of rigidly adhering to a strong internal control system include:-

i) Most internal controls tend to be directed at routine transactions rather than non-routine transactions. As a result it is important to ensure that where necessary the internal control procedures are adjusted to cover any non routine transactions. Rigidly adhering to the existing system could result in some transactions being carried out without appropriate controls.

ii) The potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instructions. The possibility of this happening could increase where employees rigidly follow an existing system. This will undermine the effectiveness of the system

iii) The possibility that management procedures become inadequate due to changes in conditions and compliance with procedures may deteriorate. If the existing system is rigidly followed without reviewing the control procedures to ensure that they address the current circumstances then this will undermine the effectiveness of the system.

(c) The matters to be considered in respect of a system of internal control for cash sales in a service station are whether the internal control procedures operate as expected. I would expect to find the following controls in place: -

1. Each shift should have an overall supervisor who does not perform routine duties of filling the tanks. He should however, be responsible for receiving the money and checking that the pump meter reading is in accordance with the money received from the pump attendant.
2. The fuel tanks should be dipped and quantity determined at the beginning and at the end of every shift. Thus a hand over register must be maintained and signed by the supervisors as they take over or hand over on change of shifts.
3. Meter readings at the end and the beginning of every shift should be taken and reconciled to the readings from dipping.
4. Quantity reconciliation's should be carried out and differences investigated promptly.
5. Security measures should be in place to ensure that theft of stock is minimized and the cash collected is safeguarded.
6. A register should be maintained to monitor sales and stock quantities on daily basis.
7. A bank account should be maintained where all the day's collections are banked on a daily basis
8. If possible, the pump attendants should be assigned to specific pumps on a daily basis so that they can be held responsible for any shortages.
9. Use of modern electronic pumps that measure sales accurately.
10. Bank the sales regularly, so that as little cash as possible is kept in the station at any one time.
11. The mechanics undertaking the repairs should maintain a record of all the vehicles that they have repaired and the amount charged. A supervisor should review this and the cash collected reconciled to the record.
12. The station should employ trustworthy people who should be properly trained in the roles that they perform at the station.

QUESTION FOUR

(a) and(b)(i)

The audit assistant has used a flow chart to document his understanding of the accounting and internal control system over the company's procedure. This is an important step in the audit because it assists in building the auditor's understanding of the system. The test of controls are carried out where the auditor wishes to rely on some of the controls to reduce the level of substantive testing to be carried out on the payroll expenses. The results of the test of controls are therefore important to support the level of substantive testing that the audit assistant has planned to carry out and ultimately to support his conclusion on whether there is any misstatement in the payroll expenses.
This evidence is reliable because it has been prepared by the auditor and is in writing.

(ii) The statement provides evidence as to the appropriateness of the depreciation policy adopted by management. This would be necessary to inquire further the reasons behind the choice of ten years as the expected useful life and where possible to get this in writing. Further evidence could be obtained by considering the useful lives of similar items of plant in the past or consulting trade journals, which may detail the relevant information. If the depreciation policy adopted is considered reasonable then the auditor should re-compute the depreciation charge for the year as a test for completeness and accuracy of what the client has provided for.

To make the oral representation from management more reliable the auditor should seek to obtain other information to corroborate what the directors have indicated.

(iii) The letter provides evidence that the company will be able to access credit facilities in the next foreseeable future and therefore mitigate any factors that could be raising questions as to the going concern of the company. As the evidence is from a source external to the company, it is reliable but would be more so if the letter had been sent direct to the auditors.

(iv) Attendance at a clients stock-take and performance of test counts provide evidence as to the existence of stock and whether the stock take was properly conducted and the whether the results can be relied upon. As the evidence was documentary, prepared by a member of the audit firm, and is based on physical inspection, it is very reliable. The items counted should be agreed to the final stock valuation by the client to confirm the completeness and accuracy of the stock valuation.

(v) Direct confirmation from a debtor provides reliable evidence as to the existence and accuracy of the debtors figures included in the balance sheet as the evidence is documentary, and from a source external to the company. To further support the evidence, the receipt of cash from the debtor, after the year end could be checked.

QUESTION FIVE

(a) An audit program sets out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. Audit programmes consists of are a list of the audit objectives and the audit procedures to be performed by audit staff in order to obtain sufficient appropriate audit evidence and to be able to form a conclusion on the relevant account balance or event. The procedures consist of an appropriate mix of tests of control and substantive procedures based on the planned audit approach for each material financial statement assertion.

The program will also serve as a means of monitoring and co-ordinating the progress of an audit. The programme should be designed with columns alongside each procedure for staff members to enter their initials and date of completion of the performance of each procedure and to note the reference of the working paper detailing the results of the tests performed and conclusions drawn.

(b) Audit programs may either be standardized or tailored to clients' requirements.

It used to be common for audit firms to preprint standardized audit programmes, usually one set for larger entities and another set for smaller entities.

The advantages were: -

(i) A consistent approach to all audits
(ii) Reduced risk of procedures being omitted
(iii) Reviewers could quickly check the progress of the audit being familiar with the contents of the programme.

Disadvantages

(i) They stifle initiative in that audit staff consider procedures laid out in audit program as the maximum they need to do

(ii) Different clients may require different procedures to be carried out yet with a standardized program, the procedures are the same.
(iii) A lot of flexibility is required in the design of audit procedures so as to ensure all unique features of a client are addressed. This is not possible with a standardised audit program.

These disadvantages can be overcome by the use of tailored audit programmes. Although most firms continue to provide model audit programmes, these can be tailored to the specific circumstances of each engagement. The benefits of this approach are: -

(i) The design of procedures and the names of the documents and records detailed in the programme match the actual accounting system and the entity.
(ii) The balance between tests of control and substantive procedures can be varied to match the preliminary assessment of inherent and control risk separately for each major financial statement assertion.
(iii) It provides engagement staff with greater control over the audit based on their knowledge of the entity and the specific audit risks. This, in turn, results in a better understanding of the purpose of each procedure since the staff member performing the procedure will have been involved in designing the programmes being followed.

(c) AUDIT PROGRAMME

AUDIT AREA: - Fixed assets	Prepared by:
Client:	Date:
Period:	Reviewed by:
	Date:

a) Tests of control:
Tests of controls

i) Confirm that acquisitions and disposals of fixed assets are properly authorized.
ii) Verify that a fixed assets register is maintained and the balance reconciles to the ledger

Substantive procedures: -

(v) **Freehold and leasehold land and buildings:**

Examine a sample of title deeds, land registry certificates, conveyance, documentation from solicitors and leases. Pay particular attention to any encumbrances i.e. mortgages or other securities held over assets. (This tests ownership, right and obligations and disclosures).
Inspect directors' minute book to ensure all title deeds, conveyances, tenancy agreements and leases are properly authorized (occurrence).
Check a sample of entries in the fixed asset register and trace back to source documentation to ensure assets are properly stated at cost. (valuation).
Review company policies for depreciation (with exception of freehold land) and ensure appropriate in the light of the useful life of the building (commonly over 50 years) and ensure that freehold land is not depreciated (valuation and measurement).
Check a sample of calculations of depreciation and ensure that it is done accurately and in line with company policy (measurement).
Review assets and establish the need for any write down for impairments in value. Discuss with management (valuation).
If freehold or leasehold assets are let to third parties inspect tenancy agreements and perform analytical procedures on rental income (Rights and obligations).

viii) Ensure freehold land and buildings are stated at cost or valuation less accumulated depreciation. If revaluation is performed in one year of audit, give the name and qualification of the valuer and state the basis of valuation (disclosure).

ix) Physically inspect a sample of assets (existence).

x) Ensure that the fixed asset register reconciles to the nominal ledger.

b) **Plant, machinery, fixtures and fittings**

i) Examine a sample of invoices contracts, finance leases or other evidence of title to assets including vehicle registration documents (ownership).

ii) Review company policies for depreciation and ensure it is appropriate in the light of the useful life of the assets.

iii) Check a sample of calculations of depreciation and ensure that it is done accurately and in line with company policy (measurement)

iv) Review assets and establish the need for any write down for impairments in value. Discuss with directors (valuations).

v) Ensure that VAT is appropriately capitalized where it is not recoverable (valuation).

vi) Physically inspect a sample of assets (existence).

QUESTION SIX

a) Representations by management are one source of audit evidence. They may be an important part of audit evidence in the audit of companies of all sizes.

ISA 580 management representations, requires that auditors obtain written confirmation of appropriate representations before the audit report is issued.

Representations are required:-

i) To allow directors to acknowledge their collective responsibility for the preparation of financial statements and to confirm that they have approved them.

ii) To confirm matters material to the financial statements where the representations are critical to obtaining sufficient, appropriate audit evidence.

iii) Critical representations will be those where knowledge of the facts is confined to management (e.g. management‗s intention to dispose off major assets) and those where the matter is principally one of judgment and opinion (e.g. with respect to litigation process or on the trading position of one particular customer or the appropriateness of change in accounting policy)

NB: _ Representations are not a substitute for other evidence that should be available and auditors should ensure that representations are reasonable and consistent with the auditor‗s knowledge of the business. Any contradiction between the representations made and other evidence obtained should be thoroughly investigated.

b) ―With respect to the debts due from the overseas agent, we acknowledge: -

i) That we have included all such amounts as owed and no amounts outstanding are unrecorded.

ii) That as at 31 December 2000, the amounts owed by the agent total to Sh.270 million.

iii) That there is no reason to believe that the amount is not recoverable from the agent overseas. However, in the determination of provision for doubtful debts, this figure is included to determine the general provision.

c) Audit procedures
Existence and title

i) Carry out a debtors circularisation i.e. send the debtor a circular. If they reply, then at least one can be assured they exist and whether or not they owe the company any money.
ii) Verify if there are any payments that have been received from these debtors after year end.
iii) In the absence of any contradiction, the directors' representations would be relied upon.

Valuation

i) I would check that the balance is made up of specific invoices relating to recent transactions and enquiring into any balances which appear to be dispute or old.
ii) Verify if there are any payments that have been received from these debtors after year end.
iii) I would discuss with management the recoverability of balances that are in dispute or appear doubtful.
iv) Seek any information that could indicate that some of the debtors might be unable to pay e.g. bankruptcy of a debtor.

Disclosure

i) Compare the method of disclosure adopted by management with what is recommended by IAS and company's Act e.g. is the debt shown net of any provisions if necessary. Verify that the debtors are correctly classified as current assets;
ii) Management should confirm in their representation that they have disclosed all the relevant information in relation to debtors.

(d) Management maybe unwilling to sign letters of representations. If management declines the auditor should inform management that he will himself prepare a statement in writing setting out his understanding of any representations that may have been made during the course of the audit and then sends this statement to management with a request for confirmation that the auditor's understanding of the representation is correct.

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

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

QUESTION SEVEN

a) The auditors' liability may be grouped into two: -

(i) Liability under statute either civil or criminal liability
(ii) Liability arising from negligence under common law.

Liability for damages for material misstatements in published accounts, may arise from any of the following situations:

i. His failure to detect material error or fraud, that he would have been reasonably expected to detect.
ii. Carelessness and/or dishonesty on the part of the auditor
iii. Falsification of accounting records or documents
iv. Publishing a misleading statement intended to deceive members or creditors.
v. In any proceedings for negligence, breach of duty or breach of trust, the court may relieve the auditor from his liability if: -
vi. He acted reasonably and honestly
vii. Having regard to all circumstances of the case he ought fairly to be excused for the negligence or default.
viii. If he carried out his work in accordance with generally accepted auditing standards.

b) The company's Act recognizes the auditors responsibilities to: -

i) His client whom he owes a primary duty of care.
ii) To third parties under tort of negligence.
iii) Government under criminal law.

Under the law of contract, only persons in a contractual relationship with the auditor can sue i.e. the client company.

NB:- Individual Shareholders do not have a contract with the auditor hence they cannot sue in contract.

In the tort of negligence, the plaintiff i.e. the third party must prove that:-

a) The defendant (i.e. auditor) owes a duty of care.
b) The defendant has breached the appropriate standard of care i.e. has been negligent
c) The plaintiff has suffered a financial loss as a direct result of the defendants breach.

(c) Audit risk may be minimized in two ways:-
(a) By ensuring that planning is adequate.
(b) By following ISA 220 on quality control

(a) Planning: -
If an auditor plans an audit properly, those areas of the audit that are potentially risky will have been identified, and the auditor can ensure that resources are devoted to those areas to minimize the risk of misstatement in the financial statements.

- Ensuring that the audit objectives are known e.g. statutory audit only, and therefore ensure that the client accepts this by sending a signed copy of the engagement letter back to the auditor. The auditor is not looking for any immaterial fraud as this would not affect the true and fair view given by the financial statements.
- Planning the audit will ensure that work is directed to cover the whole of the company's accounting systems. Thus reviewing last year's files and discussions with management will identify all the accounting systems – adequate audit programmes can then be written to cover all of these systems.
- If particularly difficult or critical areas come to light then additional resources will be devoted to these to investigate the problem fully. Thus last year's file

may note a difficult stock-take; therefore an experienced senior may be sent to attend this year rather than a semi-senior or junior staff member.

The aim of planning, therefore, is to identify risk areas early in the audit and to ensure that appropriate action is taken to minimize the potential risk that they pose.

(b) Other areas

ISA 220 notes that if the auditor ensures that all jobs are done to a high standard, this in itself will minimize the amount of risk involved. A complete, well presented and referenced audit file is likely to prove of much more value in court than a shoddy and only partly referenced file.

Particular procedures to employ to ensure that audit work is of a high standard include:

- observing all Auditing Standards;
- before accepting any appointment, ensuring that there are no conflicts of interest between the firm‘s duty as auditors and other non-professional situations e.g., client being a close relative;
- following from above, also ensuring that potential clients are of a good standing e.g. not potentially insolvent; management have integrity.
- ensuring that the firm has the skills necessary to perform the service for the client e.g., detailed use of computer auditing if the client has a highly computerized accounting system;
- ensuring that consultative procedures are available to reconcile problems between staff and partners;
- ensuring that full file reviews are carried out either by another auditing firm, or by another office of the same firm.

QUESTION EIGHT

a) Manual operations and controls that might have been applied to this invoice are:

1. A proper system for the preparation of invoices:

   - Independent preparation - invoices should have been prepared and sales journals entered up (or invoices summarized, where journals were not kept) by a section separate from the sales ledger sections. This section should also have been separate from the dispatch of goods and cash collection.

   - Sales prices of goods should be authorized in writing. A responsible official, who should have been independent of the accounts department, should authorize discount and special terms.

i. Controls to ensure that all invoices and credit notes are entered in the books.

   - Pre numbering invoices – invoices and credit notes should have been pre-numbered and filed, after entry in the books in numerical order.
   - The processed invoice should have been received and any missing numbers investigated. A responsible official independent of the sales ledger & cash receipts personnel should have authorized any spoilt, cancelled or altered invoice.

ii. A control to ensure that all authorized transactions are recorded in the sales ledger.

- Authorized invoices should be pre-listed determining a total for posting to an independent control account, before the ledger personnel process them. The totals of the ledger posting runs (both nominal and personal account) should have been agreed back to the control account.

b) Input controls serve to ensure the completeness, accuracy and authorization of input. To ensure completeness the following controls can be set up:

i. One for one checks i.e. each input is checked to output.
ii. Batch control totals and hash totals. These controls are often used where documents (e.g. invoices) are grouped together and processed in a single block.

A batch total is the sum of one of the numerical fields on the documents in the batch e.g. gross amount of the purchase invoice. This total is calculated normally and the documents are then input into the computer. The computer then calculates the batch total and this is compared with the manually calculated total. If they are different, then an error has occurred, perhaps an invoice value has been mis-keyed or a document may have been omitted from input altogether.

A hash total works in exactly the same way as a batch total but a different type of field is used e.g. the supplier code number. Unlike the batch total, the value of the hash total is meaningless but is still used for control purposes to detect errors on input or omissions.

B) Document counts.
C) Sequence checks.
D) Matching each master file record to a transaction record.

To ensure accuracy, the following controls can be set up:

i. Check digits
These are a means of control in that they ascertain whether or not a number is valid. A formula is used to calculate the number itself. The computer will then detect if the number is ever input correctly.

ii. Reasonableness: Checks to ensure data is within certain ranges.

iii. Existence checks: e.g. to check that the supplier account exists.

iv. Manual controls e.g. batch and arithmetic checks.

To ensure input is properly authorized, the following controls can be set up.
- Manual authorization
- Clerical review of transactions.
- One for one checking of amendments to standing data.
- Programmed checks on authorization limits.

c) Audit Tests

1. The auditor should inspect the invoice for the date to ensure that it relates to the client‘s financial period.
2. The auditor should consider whether the supplier‘s name appears on the list for authorized suppliers of the company to determine whether orders to such supplier are authorized.

3. The auditor should recompute the value of the invoice and compare with that on the invoice to ensure arithmetic accuracy of the invoice.
4. The auditor should compare the goods inward note content with the stock records to ensure that goods were infact received by the company.

MAY 2010

QUESTION ONE

A & B

The framework for the preparation and presentation of financial statements, identifies the following users of financial statements:

1. Investors: The providers of risk capital and their advisors are concerned with the risk inherent in, and return provided by, their investment. They need information to help them determine whether they should buy, hold or sell their shares.

   Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
2. Employees: Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
3. Lenders: Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them will be paid when due.
4. Suppliers and other trade creditors: These are interested in information that enables them to determine whether amounts owing to them will be paid when due.
5. Customers: They have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with, or are dependent on the enterprise.
6. Governments and their agencies: These are interested in the allocation of resources and therefore, the activities of enterprises. They also require information in order to regulate the activities of the enterprises, taxation policies and as the basis for national income and similar statistics.
7. Public: Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

(b) The consequences an auditor of giving an unqualified opinion when he knows that there are material inaccuracies in the financial statements is that he exposes himself to claims of negligence. In addition, he risks:

- i) Having practising certificate withdrawn for professional misconduct
- ii) Ruining the reputation of the firm
- iii) Claims for damages against him by the company and other third parties
- iv) Risk of criminal charges for issuing a misleading report.

QUESTION TWO

E) The audit objectives of internal controls on fixed asset would be to ensure that the internal control objectives over fixed assets have been achieved. These objectives include:

- i. Fixed assets are correctly recorded, adequately secured and properly maintained.
- ii. Acquisitions and disposals of fixed assets are properly authorized.
- iii. Acquisitions and disposals of fixed assets are for the most favourable price possible.
- iv. Fixed assets are properly recorded, appropriately depreciated and written down where necessary.
- v. Safeguard assets from misuse.

B) Audit procedures to verify directors' fees.

i) A schedule should be obtained from the client showing the make up of the directors' remuneration;

ii) The amounts paid in respect of each individual should be verified by reference to the company's accounting records and the service agreements or a board minute in respect of management remuneration or to the articles of association or annual general meeting minute in respect of fees for services as directors.

iii) The auditor should confirm that all directors' emoluments have been disclosed in the financial statements as required by the companies Act and have been appropriately taxed.

C) Verification of building extension

i. Ensure that proper authorisation was granted to build the extension (evidence by minutes of the board meeting) either by the board or a designated official. (Evidenced by his signature).

ii. Ensure that all the costs of the extension has been properly capitalized. This is of special importance where any of the directors or senior executives are enumerated by commission on profits, as the figure upon which commission is calculated will be inflated if revenue expenditure is incorrectly allocated to capital.

iii. Physically inspect the building to verify the physical existence of the extension.

iv. Examine documents of title to the building, to ensure that the building together with the extension rightfully belongs to the client.

v. Ensure that the cost of the extension has been properly determined (i.e. the extension is properly valued). To do this: -

a. Ensure the Company's system for allocating costs to the extension is appropriate. Such costs include cost of labour, construction materials etc.

b. Ensure the costs included relate to the project by taking a sample of costs included and tracing back to costings and source documentation.

QUESTION THREE

A) A micro-computer (including laptop) may be used by the auditor in the following ways to assist his audit work: -

1. Flowcharting clients systems

   Specialist flowcharting packages can assist the auditor in the production of clear, well presented flowcharts. The use of such packages ensures that the flow charts are legible and can be easily updated when systems change, unlike manually produced flowcharts.

2. Preparation of audit programmes

   Audit programmes can be typed into a word processor, which again will allow for easy updating in the following years. Some firms may also have standard audit tests kept on a database within the word processor when such tests are required, they are simply copied into the audit program.

3. Analytical procedures

   A standard template can be set up on a spreadsheet package. Onto this template, the auditor inputs key details such as balance sheet totals from the financial statement. The spreadsheet then calculates key accounting ratios to assist the auditor with the analytical procedures.

4. Preparation of audit working papers

   Word processing packages can be used in documenting the audit evidence gathered.

5. Preparing correspondences with the client such as faxes, management letters and engagement letter among others.
6. In random sample selection statistical packages can assist in sample selection and in performing the required mathematical computations.

B)

i. Embedded audit facilities

This module is a CAAT in which code prepared by the auditor is embedded in the client's software. The code may be designed, for example, to replicate a specific aspect of a control procedure, or to record details of certain transactions in a file accessible only to the auditor. Thus, it may be used as both a test of control or as a substantive procedure. (This CAAT is particularly applicable to continuous auditing.

ii. Integrated test facilities (ITF)

Is a facility forming part of the client's software that enables the auditor's test data to be integrated and processed with the client's live input data. The facility ensures that the test data updates special dummy files, rather than actual operating files. The dummy files are examined to ensure that the test data has been processed in the manner expected. This procedure provides evidence of the effectiveness of design of programmed control procedures as well as aspects of the effectiveness of operation.

C) Types of audit software

2. A spreadsheet package
   This provides the auditor with a large worksheet which he can be able to use to carryout mathematical functions regarding his audit work such as casting client ledgers and carrying out analytical procedures.

3. Word Processing
   This is a package that enables the auditor to carry out his word processing work such as editing, copying, typing and typesetting.

D) The controls that must be exercised by the auditor include:

1. Back up of files

Backup copies of all audit files kept on the computer should be made regularly at least once per day. These backup copies should be kept in a separate location from the microcomputer or laptop. If the microcomputer is lost or damaged, the copy files will be used to continue work on that client.

When an audit is finished, the client files are taken off the computer to make room for the next clients' files, at least two or three backup copies should be made to ensure that if one copy becomes corrupted or lost, then the files can be retrieved from the second copy of the files.

2. Security of files

Audit information on clients can be very sensitive. Adequate procedures must therefore be in force to ensure that only authorized audit staff can gain access to the audit information. All audit computers should therefore be protected by passwords and disks with client data stored in safe locations e.g. in a fireproof safe.

Care must also be taken to ensure that computers holding client data are not stolen. If a computer is left at a client's premises overnight, then it should either be locked in a safe or securely chained and padlocked to a table.

3. Adequacy of information

There is a danger with computers that not all the data or reasoning used to reach a particular decision will be documented. This can arise due to lack of ability to use the system. Adequate documentation must therefore be kept including print outs of all major documents for future reference, together with the reasons for decisions made.

4. Testing of programs

Before any program is used on audits, it should be tested to ensure that it is as far as possible error free.

QUESTION FOUR

B) A qualified report is a modified audit report issued when there are circumstances such that an unqualified opinion cannot be issued.
An auditor may be unable to express an unqualified opinion when:

i. There is a limitation on the scope of his work caused by:
- Imposed by entity e.g. when engagement terms specify that he won't carry out procedures that he believes to be necessary
- Circumstance e.g. appointment after stock taking
- Inability to carry out audit procedures believed to be necessary e.g. because the accounting records are destroyed or corrupt.

ii. There is a disagreement with management regarding the acceptability of the accounting policies selected, methods of their application or adequacy of financial statements disclosure.
The qualifications can be summarized in the matrix:

Nature of circumstance	Material but not pervasive	Material and pervasive
1. Limitation of scope The auditor is unable to carry out procedures because of a lack of evidence e.g. lack of accounting records that have been lost or destroyed, or a lack of adequate information and explanations from directors	‗Except for' opinion	Disclaimer of opinion The auditor is unable to form an opinion and does not know whether the financial statements give a true and fair view.
2. Disagreement The auditor disagrees with the accounting treatment or disclosure of a matter such as the non-provision for a doubtful debt.	‗Except for' opinion	Adverse opinion The financial statements do not give a true and fair view.

Explanation of Matrix

„Except for" opinion (referred to as qualified opinion in ISA 700) should be expressedwhen the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management or limitation on scope is not so material and pervasive as to require an adverse opinion or disclaimer of opinion.

A disclaimer of opinion should be expressed when the possible effect of a limitation onscope is so material and pervasive that the auditor has been unable to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

(b) When forming an opinion, the auditors should consider whether:

- Proper returns adequate for their audit have been received from branches not visited by them (where applicable)
- The company's balance sheet and its profit and loss account are in agreement with the accounting records and returns.
- Such information and explanations as auditors think necessary for the performance of their duties have been received from the company's officers.
- The directors' report is consistent with the financial statements.
- The financial statement comply with the requirements of the company's Act
- The financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS)

(c) Basic elements of the unqualified audit report.

1. Title
   Audit reports should be addressed to the members of the company (on whose behalf the audit is undertaken) in the absence of alternative statutory or contractual agreements (e.g. in the case of a non-statutory audit).

2. Introductory paragraph
   It identifies the financial statements audited by the use of page numbers, to distinguish such information from other documents that have not been subject to audit e.g. chairman's report.
   This paragraph also refers to the accounting convention under which the financial statements have been prepared.
3. Statement of responsibility of directors and auditors (covered earlier)

4. Basis of opinion (scope paragraph)
   Audit carried out in accordance with the International Standards on Auditing and Company's Act requirements and other statutory requirements.

5. A statement that the audit was planned and performed to obtain reasonable assurance that financial statements are free from material misstatements.

6. It should describe an audit as including:

   a. Examining on a test basis evidence to support the financial statement amounts and disclosures.
   b. Assessing the accounting policies used in preparing the financial statements
   c. Assessing the significant estimates made by directors in preparation of financial statements.
   d. Evaluating the overall financial statement presentation.
7. It should clearly state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with financial reporting framework and their compliance with statutory requirements.

8. It should date the report as of audit completion date i.e. when the auditor receives all evidence required to support his opinion.
9. It should be signed in the audit firm's name and should name the audit firm office.

QUESTION FIVE

(A) According to ISA 500 —Audit evidence‖ the auditor's judgment as to what is sufficientappropriate audit evidence is influenced by factors such as:

i. The auditor's assessment of the nature and level of inherent risk at both the financial statement level and the account balance or class of transactions level.
ii. Nature of the accounting and internal control systems and the assessment of control risk.
iii. Materiality of item being examined.
iv. Experience gained during previous audits
v. Results of audit procedures including fraud or error, which may have been found.
vi. Source and reliability of information available.

NB: Sufficiency of audit evidence refers to the quantity of audit evidence. Audit evidence is considered to be sufficient if auditor can be able to reach a conclusion on an audit objective based on that information.

Appropriate audit evidence refers to the quality of audit evidence, which is assessed in terms of the relevance, and reliability of the evidence.

Relevant audit evidence provides the auditor with audit evidence and information regarding management's assertions of the financial statements. These assertion include:

i. Existence: An asset or liability exists at a given date.
ii. Rights and obligations: An asset or liability pertains to the entity at a given date.
iii. Occurrence: A transaction or event took place, which pertains to the entity during the period.
iv. Completeness: There are no unrecorded assets, liabilities, transactions or undisclosed items.
v. Valuation: An asset or liability is recorded at an appropriate carrying value.
vi. Measurement: A transaction or event is recorded at the proper amount and revenue or expenses are allocated to the proper period.
vii. Presentation and disclosure: An item is disclosed, classified and described in accordance with the applicable financial reporting framework.

(B) Factors that would influence the auditors to accept third party certificates as audit evidence include:

1. Whether the third party be reliably determined to be knowledgeable in the mater for which he is providing the certificate.
2. The integrity of the source for the certificate – can the source be said to be honest or independent of the client.
3. The relationship of the source with the client. For instance, a certificate from a related party may not be as reliable as certificate issued on arm's length transaction by an independent party.
4. Previous experience with the third party. If the certificates given by the third party previously have proved unreliable, chances are that the certificate would be unreliable.

(c) The reliability of audit evidence is influenced by: -

1) Its source: internal or external, and

2) By its nature: visual, documentary or oral. While the reliability of audit evidence is dependent on individual circumstances, the following generalizations will help in assessing the reliability of audit evidence:
   (i) Audit evidence from external sources (e.g. confirmation received from a third party) is more reliable than that generated internally.
   (ii) Audit evidence generated internally is more reliable when the related accounting and internal control systems are effective.
   (iii) Audit evidence obtained directly by the auditor is more reliable than that obtained from the entity.
   (iv) Audit evidence in the form of documents and written representations is more reliable than oral representations.

NB: Audit evidence is more persuasive when items of evidence from different sources or of different nature are consistent. Thus, the auditor may obtain a cumulative degree of confidence higher than would be obtained from items of audit evidence when considered individually.

Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional procedures are necessary to resolve the inconsistency.

QUESTION SIX

A. The preparation of a bank reconciliation statement is carried out to reconcile the balances on the cash book to the company with the bank statement prepared by the bank and sent periodically to the entity.
   It is mainly carried out to ensure that all receipts and payments are promptly and accurately recorded.

   Controls procedures over the bank reconciliation include: -

   (i) Bank reconciliation should be prepared at least monthly.
   (ii) The person responsible for preparation should be independent of the receipts and payments function or, alternatively, an independent person should check the reconciliation.
   (iii) If the reconciliation is prepared by an independent person, he should obtain bank statements directly from the bank and hold them until the reconciliation is completed.
   (iv) The preparation should preferably include a check of at least a sample of receipts and payments against items on the bank statements.

The tests of control I would carry out on the bank reconciliation includes: -

   (i) Checking whether the reconciliations are indeed prepared as required.
   (ii) Examine evidence of independent review of bank reconciliations e.g. a signature of reviewer.
   (iii) Examine evidence of follow-up of outstanding items on bank reconciliation‘s.
   Pay particular attention to old outstanding reconciling items that should be written back such as old, un-presented cheques.
   (iv) Verify that the reconciliations are accurately prepared by checking costs and that the current balances are picked as per the cashbook and bank statements.

(c) Maintenance of a fixed assets register.

A fixed assets register is a list of all the fixed assets owned by a company. The company requires a fixed asset register in order to control and identify all the fixed assets, which it owns. The register should show: -

i. The serial number allocated to the asset. (Ideally, each asset should have its own unique identity number).
ii. Details of the type and specification of asset.
iii. Name of the supplier and date of purchase of the asset.
iv. Cost of the asset
v. Rate of depreciation and total depreciation charged to date.
vi. Location
vii. Expenditure incurred by way of maintenance and repair charges on the asset.
viii. Current net book value of the asset.

Every year, the auditor should select some items from the fixed asset, register and physically check their existence and condition. This ensures that items shown in the balance sheet are still in existence and are in good condition and have not been scrapped without a record being made in the accounting records

The company should also require that individual assets are checked against the fixed asset register on a regular basis and that periodically the register is reconciled to the nominal ledger, as part of its internal control system.

(c) The existence of passwords in a micro- computer accounting system is aimed at achieving the following objectives:

- To restrict access to the computer program to authorised persons only;
- To protect the data and programs against unauthorised amendment. Employees are granted password rights that give them varying access rights. This ensures that amendments to data can only be made by those with the relevant access rights.

To confirm that these objectives are met the auditor should verify whether appropriate password controls are in place. He should also verify whether employees are given password rights that are appropriate for their duties and that there is appropriate segregation of duties in the rights awarded. The auditor should also inquire there have been any cases of data corruption or unauthorised amendements.

QUESTION SEVEN

(b) According to ISA 400, ―Risk assessments and internal control‖, the internal controlsystem means all the policies and procedures adopted by the management of an entity, to assist in achieving managements' objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of error and fraud, the accuracy and completeness of accounting records and the timely preparation of reliable financial information.

NB: The internal control system extends beyond those matters, which relate directly to the functions of the accounting system and comprises:

(i) ―The control environment‖ which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the entity.
ii. Control procedure: procedures established to achieve the entity's specific objectives such as the ones mentioned in (a) above.

(c) this question requires you to discuss the controls that the owner of a medium size wholesale business should put in place to facilitate the detection and prevention of errors and frauds.

The controls should include the following:

(i) Organisational Plans/Chart

The business should have proper organisation plans. An organisation plan shows clearly the various departments within the business, their functions and the persons charged with ensuring that such functions are fulfilled. Fir example there should be a unit to carry out the purchase of stock and another to sell the stock and make the collections from customers.

The functions of every department are specified and the duties of every individual in the department are specified. Delegation of authority and limits of authority should be well and clearly defined. Such a plan boosts accountability within the organisation and reduce the incidence of fraud and error..

(ii) Segregation of Duties

This refers to the separation of the various duties and responsibilities such that one person cannot process and record complete transactions from beginning to the end without being checked by another person. For example in the purchase of stock the duties of raising the purchase order, authorising the order, placing the order with the supplier, receiving the stock and recording the transaction in the ledger should be performed by independent persons. This will deter fraud and detect since the work of every person in checked by another person.

(iii) Physical Controls

These are security measures concerned with the custody of assets by limiting access to authorised people only.

For example cash received at the business should be kept in saves awaiting banking. Within the business premises there should be CCTVc cameras. These measures will reduce the risk of misappropriation of assets.

(iv) Authorisation and Approval

Transactions that commit organisation‘s resources should be subject to authorisation and approval by a responsible official. The limits for authorisation should also be specified in the organization plan. For example before paying suppliers a senior manager within the business should authorise the payments. This will deter fraud by checking that all payments being made are genuine.

(v) Arithmetical and Accounting Control.

These are controls within the accounting function, which check that transactions are authorised, correctly and accurately recorded. This is aimed at ensuring completeness and accuracy of the accounting records. For example before paying suppliers a reconciliation should be prepared between the suppliers statement and the ledger balance. This will assist in detecting any transactions that have not been recorded in the ledger or where the supplier is claiming payment for fraudulent supplies. A bank reconciliation statement should also be prepared as a check against any errors or fraudulent transactions going through the cash book.

(vi) Personnel

The proper functioning of any system is dependent on the competence and integrity of those operating it. The business must therefore recruit competent staff that have integrity. Staff should be assigned responsibilities that match their capabilities. Staff should undergo proper training to ensure that the operations are carried out in the best way possible.

(vii) Supervision

Day to day transactions and their recording should be subjected to supervision by competent responsible officials. This will increase the level of accountability and consequently reduce the possibility of fraud and errors.

(viii) Management Controls

These controls are exercised by management outside the day to day routine of the system. They include:

- Review of management accounts.
- Comparison of actual performance with budgets.

Such reviews by the management of the business will assist in highlighting if there are any significant errors and frauds that manifest themselves in the financial records.

(ix) Rotation of Duties

Duties should be rotated between personnel at the same level. Staff should be encouraged to take annual leave; this will provide an opportunity for their work to be checked by an independent person.

(x) Routine and Automatic Checks.

These are checks conducted on routine duties and operations to ensure that they are operating efficiently. Such checks are conducted on a surprise basis to minimise errors and frauds. These include controls such as surprise cash counts and physical inspection of stock at the shops. Such checks will deter staff from perpetrating any frauds.

QUESTION EIGHT

(a) Cold review is the review done by an audit review department. This team has the job of reviewing in detail the work performed by an audit group and ensuring that the audit has been conducted in accordance with the firm‘s standard.

It is done as a quality control procedure to ensure that every audit team has adhered to the firm‘s standards as a way of minimizing exposure to negligence claims regarding the work done by the audit firm.

(b) Peer review may be described as an independent review of a firm‘s accounting and auditing practices. It is intended that the review be done by practitioners upon fellow practitioners hence the team peer review.

The work of the review is limited to: -

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

- Professional aspects of the firm‘s accounting and auditing practices like maintenance of working papers work products such as financial statements.

Reasons for introducing peer review

- There is a desire on the part of professional bodies worldwide today to ensure that their members apply and observe professional standards.
- ICPAK deems it appropriate to ensure adherence to existing technical standards through this mechanism of monitoring compliance.
- It is better for professional bodies to be self regulating than to be government regulated.

Benefits/Advantages of peer review

- To promote compliance with professional standards and other technical pronouncements.
- To provide reasonable assurance to users of financial statements that professional standards have been complied with in the performance of audit and related services.
- To gain increased user confidence in the reliability of audited financial statements.
- To promote uniform application of generally accepted methods of professional practice.
- To establish a mechanism of continuous quality improvement in professional practice and self regulatory framework for policies and procedures.
- To enhance the status of the image of CPA‘s to the public through the assurance of compliance and quality in the performance of audit and related services.
- To help ensure that auditors are competent and to identify potential problems in these regards at an early stage for necessary collective action to be taken.
- To help identify weaknesses in the audit process and provide technical assistance for professional development.

DECEMBER 2010

QUESTION ONE

(a) The auditors should take the following steps before accepting nomination as auditors of Nairobi Metal Works: -

i. The auditors should ensure that they are professionally qualified to act as auditors and not disqualified for any legal, ethical or professional reasons from acting. For example the partners in your firm should confirm that they are not servants of the company and they have not breached any of the ICPAK guidelines on professional independence.

ii. The auditors must be satisfied that the firm is able to service the clients' needs from existing resources by providing staff with the appropriate experience and qualifications at the right time to carry out the work.

iii. The auditors should gain an understanding of the nature of the client, and check on their status. This information will assist your firm in evaluating the potential risk in engaging with this client. For example your firm should not associate with clients whose management has a reputation of dishonesty.

iv. Your firm should seek references from other business associates of this proposed client. Again the references obtained will assist in evaluating the client for any potential risk.

v. According to statement no. 8 issued by ICPA (K), the auditors should, with the company's permission, communicate with the company's previous auditors. If permission is withheld, the auditors should not accept nomination. The new auditors should only accept the nomination if the previous auditors can confirm that there are no legal or professional reasons why they should not accept. If the previous auditors have been dismissed because of unwillingness to concur with unacceptable accounting policies or improper practice by the director, the new auditors should not be party to such a practice. If the reply from the old auditors indicates that such difficulties have arisen, the new auditors need to discuss them fully with the directors and be sure that they will not be faced with unacceptable ethical problems after accepting the appointment. The provisions of statement 8, are summarized in the following table: -

(b) The fee charged by auditors should be based on the time taken and the seniority of the staff involved, taking into account the costs of the auditors practice overall. Normally, hourly rates of charge are used which will vary according to the complexity of the work and the level of responsibility assumed by the practice in relation to the work.

The use of a contingency fee or percentage basis for calculating the fee is not acceptable for normal audit work. In this case, the auditor's independence could be impaired by the use of a percentage of profits after taxation as a bonus, as it could tend to discourage the auditors from proposing adjustments that reduced the profit figure. The fixed £100,000 would be acceptable if the auditors were satisfied that it was reasonable in relation to the time taken and staff employed in carrying out the audit work.

(c) Maintaining the auditors' independence is clearly essential if the audit opinion is to have credibility and the confidence of users of financial statements.

There are various ways in which the auditor‘s independence is preserved, even given the situation that audit fees are generally fixed by negotiation between the directors of a company and the auditors. Ethical guidance sets out various guidelines to safeguard the auditors‘ independence. T hese include a restriction on the percentageof total fees which a practice can obtain from a single client (15%) and restrictions preventing auditors from holding shares in the client company or otherwise being personally interested in the client‘s performance.

It is undeniable that auditors would be more independent of the client if they were not dependent on the client for fees.

The accounting profession takes the view that the best safeguards of auditor independence is provided by professional ethics and an objective attitude on the part of the auditors. It remains to be seen whether the public and the government will continue to concur with this view.

QUESTION TWO

(a)

(i) Materiality, is defined in the International Accounting Standards Committees ―Framework for the preparation and presentation of financial statements in thefollowing terms:-

―Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.‖ Materiality dependson the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful. The concept of materiality therefore guides the auditor in carrying out the audit. For example if there is a suspected misstatement in an account balance that is deemed to be material to the financial statements the auditor will extend the level of testing because the results from the testing could have an impact on the kind of opinion that the auditor will issue.

(ii) Going concern is one of the fundamental accounting assumptions and is defined by the International Standards on auditing, glossary of terms as ―an assumption that an enterprise will continue in operation for the foreseeable future, and that the enterprise has neither the intention nor the need to liquidate or to curtail materially the scale of its operations.‖

As a result, assets are valued on the basis of continued use, such as historical cost or replacement cost rather that net realizable value or liquidation value.

(b) According to ISA 570, factors which would indicate that the going concern assumption of the business entity that he is auditing is threatened include:

Financial Indicators

- Net liability or net current liability position i.e. liabilities exceed assets.
- Net current liability position i.e. where current liabilities exceed the current assets;
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short-term borrowings to finance long term assets.
- Adverse key financial ratios e.g. current ratio of less than one.
- Substantial operating losses

- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Difficulty in complying with the terms of loan agreements
- Change from credit to cash on delivery transactions with suppliers.
- Inability to obtain financing for new essential product development and other essential investments

Operating Indicators

- Loss of key management without replacement
- Loss of a major market, franchise, license or principal supplier
- Labour difficulties or shortages of important supplies

Other indications

- Non-compliance with capital or statutory requirements
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met
- Changes in legislation or government policy

NB: The significance of such indications can often be mitigated by other factors e.g. the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments or obtaining additional capital.

(c) (i) If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion and modify the auditor's report by adding an emphasis of matter paragraph that highlights the going concern problem by drawing attention to the note in the financial statements that discloses the matter set out in such a paragraph. The purpose of the emphasis of matters paragraph is to draw the attention of the user of the financial statement to the note in the financial statements that discusses the going concern issue for a better understanding.

(ii) If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate. This is because the financial statements will be misleading and the auditor needs to highlight this by either qualifying the report of by issuing an adverse opinion.

QUESTION THREE

(A) I would expect the internal auditors to carry out the work in the following areas: -

(i) Reviewing accounting systems and internal controls. This would include e.g. considering the adequacy of controls in an area like cash receipts at the supermarket and making suggestions for improvement.

(ii) Examining financial and operating information for management. Here, they would test the accuracy of the information contained in Bei Nafuu's financial and management accounts by performing both substantive procedures and tests of control.

(iii) Review of the economy, efficiency and effectiveness of operations and the functioning of non-financial controls. This might cover areas such as staff deployment or training, energy conservation, floor management.

(iv) Review of the implementation of corporate plans, policies and procedures This would involve internal auditors checking that any special company procedures were adhered to, either in the area of financial or administrative controls.

(v) Special investigations. Internal audit could be required by management to carry out any kind of review that is relevant, e.g. research into the possible effects of a new accounting policy or detailed investigation into a suspected fraud. The work of internal audit spans a wide spectrum of activities from tests that are very similar to those performed by the statutory auditor to ‗one-off' exercises for internal use by company‗s' management.

(vi) Reviewing whether the supermarket is complying with the relevant laws and regulations such as council health standards, labour laws and taxation laws.

(A) When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and test that work to confirm its adequacy for the external auditors purposes. Before evaluating any specific work with the intention of relying on it the auditor should carry out a preliminary evaluation of the function. In carrying out this evaluation the following factors should be considered:

1. Organization status

Since internal audit function is part of the entity it cannot be totally independent. To boost it‗s independence the status of the function within the organization should be such that the internal auditor reports to the highest level of management. The internal auditor should also be free of any other operating responsibility such as performing accounting functions, which may conflict with his role as an independent watchdog of controls and operations of the entity. There should be no restrictions placed upon his work by management. Such restrictions could impair the effectiveness of the function.

2. Scope of the function

The external auditor should ascertain the nature and depth of coverage of internal audit assignments. He should also ascertain whether management considers and acts upon internal audit recommendations. Where the recommendations are not acted upon this represents a weakness in the function and hence the level of reliance should consequently be reduced.

3. Technical competence

The external auditor should ascertain whether internal audit work is performed by persons having adequate technical training and proficiency as auditors. Qualifications and experience of the internal audit staff should be considered.

4. Due professional care

The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. Exercise of due professional care is evidenced by the existence of adequate audit manuals, work programs and working papers.

5. Internal audit reports

The external auditor should consider the quality of the internal audit reports prepared and submitted for management action. He should ascertain whether management considers, responds to and acts upon internal audit reports and whether there is evidence to prove that action.

6. Level of resources available

The external auditor should consider whether internal audit has adequate resources to be able to carry out their duties effectively. Such resources would include staff and computer facilities.

If having carried out the above preliminary review the auditor concludes that the internal audit function is effective and he wishes to rely on some specific work done by the internal auditor the following procedures should be carried out.

(a) The work is performed by staff who have adequate technical training and proficiency as internal auditors;

(b) the work of assistants is properly supervised, reviewed and documented;

(c) sufficient appropriate audit evidence is obtained to form a reasonable basis for the conclusions reached;
(d) the conclusions reached are appropriate;
(e) reports by the internal audit are consistent with the results of the work performed;
(f) any exceptions and unusual matters disclosed by internal audit are properly resolved;
(g) amendments to the external audit programme are required as a result of matters identified by the internal audit work;
(h) there is a need to test the work of internal audit to confirm its adequacy.

NB: The nature timing and extent of the testing of the specific work of internalauditing will depend on the external auditors judgment as to the risk and materiality of the area concerned, the preliminary assessment of internal auditing and the evaluation of specific work by internal auditing.

(c) Controls I would expect to find in Bei Nafuu Supermarkets:

1. Plan of Organization

- I would expect to find the supermarket well organized in terms of different departments such as accounting and human resource departments, each with defined responsibility.

- I would expect the shop floor to be organized into different sections where different products are kept e.g. detergents should be kept in one location different from where milk is kept.

- I would expect to find a left luggage deposit area where customers leave their luggage whilst shopping.

2. **Segregation of Duties,** this refers to assigning duties in processing of transactionsto different individuals such that one person cannot carry out a complete transaction from initiation to final recording in the financial statements without his work being checked by another person.

Duties should be segregated especially within the purchase department. Functions, which should be segregated, include:

(a) Authorization – This should be segregated such that different line managers are given various limits of authority which should depend on such factors such as their position in the organization, their integrity, qualification, competence and remuneration.

Thus, in the purchase department of Bei Nafuu, we expect authority limits to be commensurate with the cost of purchase e.g. the supermarket manager may authorize the purchase of more detergents, but the purchase of a new lorry should come from the board of directors or other senior management.

(b) Execution of duties: - Limits of authority such that a person who authorized a given transaction cannot execute the same. Thus the person authorizing the purchase should not be the one to place the purchase order.

(c) Custody of resultant assets: An official authorizing a given expenditure should not keep the asset arising out of such expenditure. Thus, the person authorizing purchases should not store the items bought but rather these items should be stored by the store department.

In addition, custody of cash and stock should be in the hands of responsible officials with a high degree of integrity.

Recording: This should be done by a person independent of the above particularly the accounting department. The records should be kept by a person with integrity and responsibility to ensure that records cannot be changed, removed or destroyed.

3) Physical Controls

These aim at limiting access to the companies' assets to only authorized persons at authorized times. Thus, Bei Nafuu's sensitive items e.g. cash and documents should be kept under lock and key. They should have security guards to provide security to the premises. They should fit fire protection devices in the company.

Any documents used should be pre-numbered and serialized to prevent misplacement of such documents. These documents include local purchase orders; goods received notes, invoices from suppliers and petty cash vouchers among others.

Installation of closed circuit TVs' on shop floor. Use of convex mirrors reflecting the customers actions watched by a guard positioned strategically.

4) Arithmetic and Accounting Controls

These are used to check the recording function of an organization to ensure that figures in the financial statements are genuine and authentic. This includes:

2. Periodic reconciliation of accounts e.g. the bank reconciliation, suppliers reconciliation (schedule or ledgers with suppliers statements)
3. Drawing of trial balance
4. Periodic balancing of accounts
5. Regular checking of totals in ledgers and agreeing them to control accounts
5. Use of electronic cash registers at paying point to record cash receipts.

These controls are essential as they provide management with information for decision-making purposes. Such information should be up to date, accurate complete and timely.

5) Personnel Controls

The controls in Bei Nafuu should be operated by qualified and competent personnel with personal integrity who understand the essence of controls.

Some of the responsibilities will call for periodic training and retraining of staff to meet the changing business conditions. The staff should be properly motivated as well.

6) Supervision

These include:

a. Low-level supervision – This should be directed to the personnel on the shop floor and should be done by trained and qualified supervisors.

b. Middle level – This should be done by line managers (effectively the branch managers of Bei Nafuu's Supermarkets) who ensure that company policies (e.g. of neat supermarket, fast moving queues) are implemented and adhered to. If properly done, it boosts low-level supervision.

c. Managerial supervision and reviews: This will be executed by top management using tools such as budgets, standard costing statements and internal audit feedback

It will also imply that managerial controls include supervisory controls and review to ensure that all other controls and company activities are operating smoothly to achieve predetermined goals.

7) Rotation of duties and vacations

Duties particularly routine duties (such as collecting cash from customers, receiving goods from suppliers) should be rotated to cut continuity of errors and fraud and act as a means of avoiding routine boredom.

More so, staff members should take up their annual leave when it falls due.

8) Routine and automatic checks

Such controls should be operated on a surprise basis and be directed to areas such as petty cash, cash collected by cashiers, wages payment and stock.

9) The quality of the internal audit department can be assessed by considering the following:

- By reviewing internal audit reports to see whether management acts on the recommendations by internal audit;
- By ascertaining whether the department is staffed by competent people with the required technical training;
- By drawing from prior year's experience on the level of reliance placed on internal auditors work.
- Whether internal audit work is properly planned and reviewed.
- The auditor should also evaluate the scope of the function and the extent of work carried out by internal audit.

QUESTION FOUR

Procedures for verifying
General provision for bad and doubtful debts
The question is very specific and requires you to detail the procedures you would carry out in verifying the general provisions.

AUDIT OBJECTIVES

- To verify that the bases applied in computing the general provision is reasonable;
- To verify that the general provision is accurately computed;
- To verify that the provision created is adequate.

AUDIT PROCEDURES

a) Obtain an understanding of the basis applied by the company in computing the general provision for bad debts. From your knowledge of the company and experience evaluate whether the basis chosen is appropriate. In particular, ensure that more provisions are created for long overdue accounts.

b) Compute the ratio of general provisions to debtors and compare this with the previous period. Obtain explanations for any significant movements.

c) Using the method applied by the company and the debtors' balances recompute the expected provision and compare the amount with what is provided for by the company.
d) Compare the prior years general provision with the actual debts that were written off during the current year as a check for the reasonability of the method applied by the company.
e) Obtain representations from management that the provisions created are adequate.

Verifying the specific provision

a) Obtain a schedule of the debtors' accounts against which specific provisions were created.
b) Obtain the reasons why these accounts were considered bad and verify whether the specific provision is adequate (whether this is below 100%)
c) Verify that all accounts that are considered bad, e.g. disputed balances are fully provided for.

(B)(i) Cut off Procedures

A cut-off procedure is a type of evidence gathering activity performed by auditors during the substantive testing stage. In particular, the cut-off procedures gathers evidence that transactions are recorded in the period to which they relate.

A cut off test, depending on its direction, provides evidence as to two types of misstatement, namely:

- A misstatement relating to completeness, where an economic event that occurs in the financial period being audited (i.e. up to and including the cut-off date) is recorded in the related account balance in the subsequent accounting period.

- A misstatement relating to validity, where an economic event that occurs in the period following the period being audited (i.e. after the cut-off date) is recorded in the related account balance in the period being audited.

A simple example in relation to accounts receivable and related sales transactions is as follows. On the cut-off date i.e. the balance sheet date the auditor obtains details (including details of the sequential identification number, customer name, product description and quantity delivered) of the last delivery advice to be issued on the cut-off date by physically examining the source documents at the close of business.

If the auditor needs evidence as to the **completeness** of accounts receivable and related sales transactions, then subsequent to the cut-off date the auditor selects a number of delivery advices with identification numbers before or including the number of the last delivery advice issued on cut-off date. The details on the delivery advices (as noted above) are traced to the relevant sales invoices and then to the accounts receivable records to ensure that the sales have been included in the accounting records on or before the cut-off date. In addition, the auditor selects a sample of sales invoices recorded in accounts receivable records in the first few days of the month following the cut-off date. All invoices selected should refer to delivery advices with identification numbers after the number of the last delivery advice issued on the cut-off date.

(ii) Audit in depth

This refers to the carrying out of detailed substantive procedures. It is characterized by extensive vouching and verification of the underlying transactions and account balances.

ISA 500 ―Audit evidence‖ defines substantive procedures as tests performed to obtain auditevidence to detect material misstatements in the financial statements and are of two types: -

a) Tests of details of transactions and balances
b) Analytical procedures

QUESTION FIVE

(a) The overall purpose of the auditors' attendance is to assess the effectiveness of

- The clients stock taking procedures. Verify that the stock take exercise is carried out per the stock instructions. This will assure the auditor that the exercise can be relied upon to provide complete and accurate figures of the stock balance;
- To verify the physical existence of the stock;
- To inspect the general condition of the stock, this will assist in concluding whether the stock is correctly valued.

Note that the auditor does not attend the stock take to count stock but to observe how the exercise is being carried out.

(b) Before the stock taking, the auditor should carry out the following: -

(i) Review prior year's working papers, familiarize himself with the nature, volume and location of stocks, consider the controls and recording procedures over stock.
(ii) Identify problem areas in relation to the system of internal control and decide whether reliance can be placed on internal auditors.
(iii) If stock held by third parties is material, or the third party is insufficiently independent or reliable, then arrange a stock-take attendance at the third party's premises otherwise, arrange third party confirmation.
(iv) If the nature of the stocks is specialized then he will need to arrange expert help or to review the client's own arrangements.
(v) Examine the client's stock taking instructions: If found inadequate, the matter should be discussed with the client with a view to improving them prior to stock-take.
(vi) Auditors should perform analytical procedures on stock as part of the planning process.

(c) During the stocktaking, the main task is to ensure that the clients staff are carrying out their duties effectively. The auditor should:

i. Make two-way test counts from stores floor to stock sheets, and from stock sheets to stores floor.
ii. Make notes of items counted, damaged stock, instances where the stock taking procedures are not being followed.
iii. Examine and test control over the stock sheets. The client should keep a stock sheet register.
iv. Examine cut off procedures. The auditor should examine the link between purchases records and stocks, and between sales records and stocks, to ensure that there is complete accord between stock and the financial records of purchases and sales, debtors and creditors. These are known as cut-off procedures.

Procedures the auditor would carry out to ensure correct cut off include:

- During stock-take attendance note the serial numbers of the last sales invoice, dispatch note and goods received note generated before the stock-take.
- After the stock-take, check the year end dispatch notes to sales invoices and the sales day book and vice versa to ensure that dispatches and the related invoice both fall before year end.

- Similarly for purchases, ensure year-end goods receipts notes and related purchase invoices are correctly treated in the current period.
- Take a sample of goods received and goods dispatched just after the year end and ensure that the related stock was not included in the count in the case of goods received, that it was included in the goods dispatched.

(v) Pay particular attention to goods held on behalf of third parties e.g. goods on consignment.

(vii) Reach a conclusion as to whether or not the stock taking was satisfactory and hence provides reliable evidence supporting the final stock figure.

(viii) To establish the physical quantities of stock, the auditor should attend the stock-take and observe how the clients‘ employees are counting stocks particularly: -

i. Are the client employees carrying out the work allotted to them properly and are they following the stock-take instructions?
ii. Does the stock appear to be recorded correctly on the stock sheets both as to description and quantity?
iii. Are all slow moving, obsolete and substandard stocks properly identified?

NOTE:-

It may be sufficient to watch the counting and recording of stock as it is done by the clients‘ employees, but it will normally be advisable for the auditor to test the efficiency of the counting by arranging for a count or recount in his presence of selected items. Items checked should be marked or noted in a way appropriate to ensure that any subsequent change can be identified.

(d) In an attempt to satisfy himself that the management procedures as regards stocks have been properly applied throughout the period, the auditor will carry out tests of control which include:-

ii. Observe physical security of stocks and environment in which they are held.
iii. Test procedures for recording of stock movements in and out of stock.
iv. Test authorization for adjustments to stock records.
v. Test authorization for write off or scrapping of stocks
vi. Test controls over recording of stock movements i.e. the use made of authorized goods received and dispatch notes.
vii. Inspect reconciliation of stock counts to stock records.
viii. Check sequences of dispatch notes and goods received notes for completeness.

QUESTION SIX

(a) Loan to three employees

- Proper authorization for the loan by the responsible official and in accordance with company policy.
- Supporting evidence as to whether the employees are bonafide employees of the organization.
- A repayment schedule of the loans. The period of repayment should not exceed the employees term of office
- Security given by the employees to secure the loan.
- Evidence to satisfy himself that the debt is good and recoverable at the balance sheet date. This will include evidence of repayments by the employee.

- Interest on the loan should be charged on normal commercial basis or where there is a concession that this is within the company‘s policy.

(b) Last call on 5,000 ordinary shares at sh.15 per share.

- Verify that the call has been made in accordance with the terms of the issue.
- Inspect paid cheques for cash paid on the last call.
- Inspect any cancelled share certificates for which the company never honoured the last call.
- Verify that proper authority was obtained to make the payment.

(c) Fire premiums

- Examine policy documents issued by the insurance company to make sure that the policy relates to the office block.
- Verify the receipt issued by the insurance company to ascertain that the amount paid was indeed sh.10, 000.00
- Ensure that the policy covers the office block against fire adequately i.e. it has not been over or under insured.
- Verify that amount paid in current year compares favourably with the previous years.

(d) Loan amounting to Sh.30 million

- Go through the board of directors‘ minutes to ensure that the loan was acquired with proper authority from the board.
- Ensure that the loan was obtained on behalf of R R Paper Mills and not for a third party. To determine this, seek evidence regarding the utilization of the money within the company.
- Verify that the loan was utilised for the approved purpose
- Determine whether the loan is being properly serviced in terms of interest and principal repayments. If no, consider the impact of the consequences of default to R Paper Mills, e.g. sale of the security, possible liquidation (hence no longer a going concern).

(e) Salesman"s commissions amounting to Sh.3,000,000

Seek evidence that the salesmen are authorized to sell the company‘s products. Their names should appear in the records for salesmen.

- Verify the terms of payment of commission. There should be a clearly laid down policy for the payment of commissions.
- Ensure that commissions are only paid against proof of sale.
- Ensure that commission paid is subjected to taxes as required by the law.

QUESTION SEVEN

(A) —Scopell refers to the auditors‘ ability to perform audit procedures deemed necessary in the circumstances. The reader needs this as an assurance that the audit has been carried out in accordance with established auditing practices or standards.

The auditors report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatements.

It should also describe the scope of the audit by stating that the audit was conducted in accordance with ISA's or in accordance with relevant national standards or practices as appropriate.
The auditors report should describe an audit as including: -

(i) Examining, on a test basis, evidence to support the financial statement amounts and disclosures.
(ii) Assessing the accounting principles used in the preparation of the financial statements.
(iii) Assessing any significant estimates made by management in the preparation of the financial statements.
(iv) Evaluating the overall financial statements presentation.

(c) The auditors distinguish their responsibilities from those of the directors in respect of the financial statements by including a statement of directors' responsibilities in the report.

Appropriate wording of this statement follows below: -

‗Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the entity as at the end of the financial year and of the profit or loss of the entity for that year. In preparing those financial statements, the directors are required to:

(i) Select suitable accounting policies and apply them consistently.
(ii) Make judgments and estimates that are reasonable and prudent.
(iii) State whether applicable accounting standards have been followed.
(iv) Prepare the financial statements on the gong concern basis unless it is inappropriate to presume that the entity will continue in business.

The directors are responsible for keeping proper accounting records which should disclose with reasonable accuracy at any time the financial position of the company and comply with the Company's Act and also take reasonable steps for the prevention and detection of fraud and other irregularities. They are also responsible for safeguarding the assets of the company.

Auditors are required to form an opinion as to whether:-

- Proper accounting records have been kept by the company.
- Proper returns adequate for their audit have been received from branches not visited by them.
- The company's balance sheet and its profit and loss account are in agreement with the accounting records and returns
- Such information and explanations as auditors think necessary for the performance of their duties have been received from the company's officers
- The auditors report is consistent with the financial statements.

c)(i) Uncertainties result from circumstances in which it is not possible for the auditor to reach any objective conclusion as to the outcome of a situation due to the circumstances themselves or as a result of a limitation on scope of the audit. Such uncertainties are resolved through the passage of time e.g. if the company is faced with a legal case say for breach of contact the actual impact on the financial statements will only be known after the case has been heard and determined. The auditor should form an opinion on the adequacy of the accounting treatment of such uncertainty. This will involve consideration of:

- The appropriateness of any accounting policies adopted by management in treating the effect of such uncertainties;
- The reasonableness of the estimates included in the Financial Statements;
- The adequacy of disclosure.
- Some inherent uncertainties are fundamental. These are uncertainties where the degree of uncertainty and its potential impact on the view given by the financial statements may be very great.

  In other situations uncertainty could be as a result of a limitation in the scope of the audit where the auditor has not been able to obtain some information that is considered necessary for the purposes of the audit.

(ii) Circumstances of disagreement arise where the auditor disagrees with the accounting treatment or disclosure of a matter such as the non-provision of a doubtful debt.

Thus, circumstances giving rise to a disagreement will include:

a) Departures from acceptable accounting policies/practices:-
   - Failure to follow an IAS
   - An unacceptable policy not allowed by IAS
   - Compliance with an IAS where this does not in the circumstances give a true and fair view.
b) Disagreement as to facts or amounts included in financial statements
c) Disagreement as to the manner or extent of disclosure of facts or amounts
d) Failure to comply with legislation.

(e) Before the adoption of International Standards on Auditing (ISA) in Kenya in 1999 (auditors were governed by the Kenyan auditing guidelines), the ―subject to‖ opinion was issued when there was a limitation in scope that was material (but not fundamental) whereas the except for opinion was given when there was a disagreement between management and auditor which was material but not fundamental.

However, with the adoption of the ISAs in 1999, an except for opinion is now issued where there is a limitation in scope or a disagreement that is material but not fundamental. This implies that a ‗subject to' opinion no longer exists under our current framework of the ISAs.

QUESTION EIGHT

A & B

The practical difficulties I would encounter as an auditor as a result of the proposed introduction of a computerized accounting system would arise from the characteristics of a computerized system which distinguish it from a manual system.

These difficulties and the ways they can be overcome include: -

1. Concentration of controls in the computer department.

The need to standardize procedures and utilize the computer resources of Leather merchants may lead to this. There is a danger of deliberate or inadvertent corruption of data of which other departments are unaware by the computer department.

During my audit work, especially during the planning stage, I will identify the extent of these controls. If such controls are concentrated in the computer department, the adequate functioning of the department will be fundamental to my audit.

2. Lack of primary records.

If Leather Merchants introduce an on-line system, then some conventional day books (such as purchase journal) may not be created. Originating documents (such as sales order) may not be created as well.

To eliminate this problem, the auditor should advise Leather Merchants to provide for computer-generated reports which will keep track of these activities.

3. Loss of audit trail

A computerized system is usually designed to limit the volume of printed data. Control is implemented by exception reporting principles so that detailed print outs of magnetically stored data are not available.

The auditor, is therefore unable to trace an individual transaction through the system from originating document to financial statements (loss of visible audit trail.)

This may result in a need for the auditor to use computer assisted audit techniques to obtain appropriate evidence that controls have functioned adequately.

4. Data needed for audit purposes may be overwritten.

   When data is stored on magnetic tape or disk, it will eventually be overwritten with new data.

   The auditor will need to plan audit testing to ensure that the appropriate data is available to him. He may need to make frequent visits to his clients' premises to ensure that he covers an adequate spread of transactions during the year.

5. The need for specialist expertise.

   It is important that the auditor employs competent staff to carry out the audit of Leather Merchants.

   This may prove rather expensive, as staff need to be knowledgeable in computer functions and processes.

6. Availability of computer time
   The use of computer assisted audit techniques involves the use of the client's computer facilities. There may be need to organize such facilities well ahead of the required dates.

(c) Benefits to client using a computerized accounting system

   i. Computerization gives rise to a strong internal control system, which prevents chances of error and frauds in an organization. (Possible if system is properly designed and implemented).
   ii. Computerization facilitates preparation of management reports that are designed to meet the information needs of all employees. This assists in decision-making and in running the affairs of the organisation more efficiently.

iii. It reduces overtime costs (as accounts are prepared much faster), which are associated with manual accounting system.

iv. Computers produce clear and neat work particularly in computations, ledgers, records and financial statements.

v. Computers enhance arithmetic accuracy (as human error is eliminated) thus leading to more accurate accounting records.

JUNE 2011

QUESTION ONE

a) **You are required to explain the meaning of the term „audit"**

i. The explanatory foreword to the International Standards on Auditing (ISA) describes audit as the independent examination of and expression of an opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.

ii. Objectives of an audit

The primary objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework and show a true and fair view. (Financial reporting framework refers to the international financial reporting standards, provisions of the companies Act and other relevant statutes and legislation). The auditor expresses an opinion as to whether the financial statements give a true and fair view of the financial position and performance of the company and cash flows.

Note that: an auditor does not certify the financial statements as true and fair butonly reports his opinion basing on the evidence obtained.

b) Advantages to a company of having its accounts audited

An audit has many benefits to the organisation or business entity.

- An audit protects the interests of the shareholders who are separated from the management of the company. This is especially the case for minority shareholders who have little say in the management of their company.
- An audit being an independent examination of the financial statements gives credibility to the financial statements. The various users can therefore place reliance on them.
- The auditors experience will enable him to make recommendations on ways of improving the accounting and the internal control system.
- An audit assists in the prevention and detection of errors and frauds through the moral and deterrent effect of an audit.

c) Directors have the following responsibilities in relation to the company"s accounting system

- Responsibility to put in place a system that will ensure proper accounting records are maintained. The Companies Act requires management to keep proper books of accounts, this is only possible with a proper accounting systems;
- They are responsible for ensuring that appropriate controls are put in place within the operation of the accounting system;
- Responsibility to continuously review the operation of the controls to ensure that they are adequate for the operations of the company;
- To ensure that the accounting system and the internal control system safeguards the company‟s assets.

d) **Limitations of an audit**

- It is not possible to detect all the frauds and errors that might have taken place during the year;
- Management might fail disclose to the auditor some of the information that is needed;
- An audit is carried out on a test basis. It might not therefore be possible to examine all the transactions. The samples selected might not be representative of the population;
- Time limit placed on the auditor‘s work. This could limit the amount of work to be performed.

QUESTION TWO

a) **You are required to explain management objectives that an internal control system (ICS) can help management achieve.**

- An ICS enables management to carry out the business in an orderly and efficient manner. Internal controls lay out the various procedures to be followed in conducting the affairs of the organisation. E.g. there will be procedures laying out the procedures to be followed in procuring raw materials to ensure that only necessary materials are procured which meet the quality standards of the company;
- An ICS ensures that the various policies that have been put in place are adhered to by employees in running the operations of the company;
- An ICS helps in safeguard the company‘s assets. Some controls are designed specifically to ensure the assets of the company are protected from theft, destruction and that they are used in the best interest of the company. This can either be directly through physical locking up or indirectly through recording. It includes assessing assets and ensuring that any access is authorised.
- ICS help in ensuring completeness and accuracy of the records maintained. The company‘s Act requires that the management of a company keep proper books of accounts. These records are the basis for the preparation of the financial statements.
- Strong internal controls help in preventing and detecting errors and frauds. The responsibility for the prevention and detection of fraud and error rests with management. This is achieved through the implementation and continuous operation of an adequate system of internal controls. Such a system reduces but does not eliminate the possibility of fraud and error.

b) **You are required to discuss five control objectives that an internal control system over sales aims to achieve.**

- To ensure that the company only sells to credit worthy customers. This is aimed at reducing the risk of selling to un credit worthy customers resulting in bad debt losses;
- To ensure that all sales made to customers are subsequently billed and recorded in the ledger;
- To ensure that all sales made are recorded in the correct financial period;
- To ensure that sales are billed at the approved selling prices;
- To follow up on payments from customers and ensure that customers are adhering to the approved terms of credit;
- To ensure that there is proper control and authorisation of bad debts write offs.

c) **Inherent limitations of an internal control system**

The question that always arises in regard to the internal control system is whether such a system could be deemed to be 100% effective.

No internal control system, however elaborate, can by itself guarantee efficient administration and completeness and accuracy of the records nor can it be proof

against fraudulent collusion, especially on the part of those holding positions of authority and trust. This implies that there are certain factors that could undermine the effective operation of an internal control system, some of which could be outside the control of management.
This is mainly due to the following inherent limitations of an internal control system:

- Management has to ensure that the benefits expected from an internal control system outweigh the costs. As a result certain important controls might not be put in place due to the costs involved. E.g. a small entity might not have the resources to employ sufficient staff to ensure proper segregation of duties.
- Most internal controls tend to be directed towards routine transactions rather than non-routine transactions. This leaves gaps that can be exploited because the non-routine transactions will not be subjected to appropriate controls.
- Human error due to carelessness, distraction, mistakes of judgment and misunderstanding instructions could undermine the effectives of the internal control system.
- A member of management or an employee could circumvent controls through collusion with persons outside or inside the entity. E.g. where duties are segregated the employees could collude to perpetrate and conceal a fraud. Such collusion will render the segregation of duties ineffective.
- Abuse of responsibility e.g. a member of management overriding an internal control
- The possibility that procedures maybe inadequate due to changes in conditions.

QUESTION THREE

a) You are required to distinguish between procedural and a balance sheet audit

I) Procedural audits entail a review of the company's procedures and records so as to ascertain whether they are accurate and reliable for decision making. These audits are ideal for organizations operating in dynamic business environments and companies whose operations are so technical and need to be updated over time. The audit concentrates on the review of operating procedures rather than on financial balances.

II) Balance sheet audits

These are audits in which the auditor starts his audit work from the balance sheet and tries to trace original entries to their final recording in a bid to prove their authencity. The auditor concentrates on proving the management assertions that are relevant to each of the balance sheet items.

This audit approach is adopted when carrying out a special assignment where the auditor is required to concentrate on the verification of the assets and the liabilities.

Very little time is spent in testing controls that management has put in place.

b) You are required to explain the nature and purpose of a post audit review

A post audit review relates to the review of the audit work at the end of the audit before the audit report is signed. The review is usually carried out by the reporting partner to ensure that the objectives of the audit have been met and the conclusion reached are supported by sufficient appropriate audit evidence. Before the reporting partner review the audit work is first reviewed by the engagement manager.

c) You are required to identify the audit procedures which would need to be carried out in order to identify material post balance sheet events

Post Balance sheet events also referred to, as subsequent events are those events both favourable and unfavourable that occurs between the balance sheet date and the date when the financial statements are authorized for issue.

The audit procedures that the auditor would carry out in regard to post balance sheet events include the following:

- Reviewing procedures management has established to ensure that subsequent events are identified and inquiring whether any such events have occurred which might affect the financial statements being reported on;
- Reading minutes of the meetings of the board of directors and audit committees held after the end of the financial period. By reading such minutes the auditor is able to identify any material subsequent events that might have occurred since this would ordinarily be discussed at these meetings;
- Review the entity's latest available interim financial statements and other reports such as budgets, cash flow forecasts. By reading such interim financial statements the auditor is able to identify any subsequent events;
- Inquiring from the entity's lawyers on litigation and legal claims against the company. This will provide further details on any developments on such litigations.;
- Inquiring from management whether any subsequent events have occurred which might affect the financial statements

QUESTION FOUR

a) Cash receipts by post

- The mail should be opened by at least two persons;
- The persons involved in the mail opening should be responsible trust worthy people;
- A listing of all cash received should be prepared and the cheques crossed ‗payee only';
- The cash received should be safely kept in a safe and should be banked intact on a daily basis;
- A daily cash received report should be prepared and reviewed by a senior official.

b) Cash collected by sales men

- A daily cash collected report should be prepared by each sales man showing the total cash received from each customer;
- The cash collection report should also show the expected cash collection basing on the stock sold and the actual amount. Any variances should be explained;
- The marketing manager should also review the cash reports on a daily basis to ensure that all the stock issued for sale has been accounted for;
- All the cash and cheques collected should be surrendered to the cashier on a daily basis. This should be kept in a safe and banked regularly;
- Debtors' statements should be sent to the customers on a monthly basis.

c) Cash sales within the premises

- An appropriate method of recording all the cash sales should be put in place. For example, the company cash install cash registers or use of cash receipts to record all the cash sales;

- The company should employ trust worthy cashiers who should under go proper training in their duties;
- On a daily basis the physical cash should be reconciled to the expected cash as per the cash register report. Any variances should be investigated and resolved;
- Cash collected should be kept in a safe and banked intact preferably on a daily basis;
- There should be adequate physical security measures such as the use of closed circuit TV cameras (CCTV) and engaging security guards.

d) Banking of cash received

- Cash received should be kept in a safe awaiting banking;
- It might be necessary to engage a security company when transporting the cash to the bank;
- Banking should be done by a person independent of the cashiering function;
- The banking hours should be rotated to reduce the security risk;
- Cash deposit slips should be prepared for all the cash banked and the amounts recorded in the cashbook.

QUESTION FIVE

Working papers refers to the documentation prepared or obtained by the auditor and retained by him in connection with the performance of his audit. Audit working papers should always be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to ascertain the work that was performed supports the conclusions reached. The auditor should record all relevant information known to him at the time, the conclusions reached based on that information and the views of management.

Why the need for preparing good working papers.

- The reporting partner needs to satisfy himself that work delegated by him has been properly performed. This is only possible by reviewing detailed working papers prepared by the audit staff that performed the work. This also aids in supervision and review of work done by audit assistants.
- Working papers provide details of problems encountered together with evidence of work performed and conclusions drawn there from in arriving at the conclusions reached. These details can also serve as a good reference point for future audits.
- Preparation of working papers encourages the auditor to adopt a methodical approach to his work.
- Working papers assist in the planning and performance of audits in future financial periods.
- If sued for negligence working papers act as evidence of work done.
- They are used for training of audit staff. Working papers contain audit programs and specimen schedules, which audit assistants, can refer to when conducting an audit.

You are required to identify one form of audit evidence that is relevant and explain in each case whether that form of evidence is reliable and sufficient

A trade debtor shown in the balance sheet

One form of audit evidence would be to obtain a direct confirmation from the debtor. This evidence is reliable because it is obtained from an independent third party and it is in writing. Such evidence is relevant in confirming the existence and also provide persuasive evidence as to ownership rights of the amount owing by the debtor. However, because of human nature, confirmations may not provide such persuasive evidence of accuracy where the entity‘s balance is in error in the other party‘s favour, e.g. an understatement of debtors.

The evidence is however not sufficient because additional information will be required to for example confirm the valuation of the balance.

A batch of work in progress

One form of audit evidence would be to observe the stock take exercise as at the end of the financial period to ensure that the WIP is accurately computed and that the results can be relied upon. In addition it would be important to confirm there are appropriate procedures to identify the stage of completion of the WIP.

This evidence is relevant in confirming the existence of the stock and also in identifying the stage of completion in determining the valuation.

The evidence obtained through observation of the process is reliable because it is evidence obtained by the auditor. However, it is not sufficient because additional information will be required to test other assertions such as the valuation of WIP. The auditor would for example need to obtain need to confirm that all costs attributable to the WIP have been taken into account in the valuation.

A contingent liability disclosed in the notes to the accounts

One form of audit evidence would be obtain a letter of representation from management on the nature of the issue bringing rise to the contingent liability and also the factors that were considered in determining the accounting treatment of the contingency. This evidence would be relevant in confirming whether the contingency has been appropriately treated in the financial statements and whether there might be need to create a provision.

Depending on the nature of the contingency it might be necessary to obtain additional information. For example if the contingent liability arises out of a legal case against the company it might be necessary to obtain an independent confirmation from the company‘s lawyers on the possible outcome of the case and a quantification of the expected liability.

You are required to discuss the quality of audit evidence generated by third parties

Quality of audit evidence refers to the reliability and relevance of the evidence.

The reliability of evidence refers to the credibility of the source of the information i.e. the question of how much trust can the auditor place on the evidence while relevance refers to the usefulness of the evidence in testing the management‘s assertions or the audit objective.

Evidence generated by third parties mainly includes direct confirmations of balances obtained from such parties and documentary evidence such as statements and invoices sent by such parties. The reliability of evidence obtained from such parties mainly depends on the following:

- The evidence is usually in writing. Documentary evidence is more reliable than oral evidence;
- The evidence is usually from an independent source. This increases its reliability. However, the auditor must be cautious to ensure that the third party is independent of the client and there is no possibility of collusion.

Examples of third party evidence include:

- Direct confirmations such as replies to debtors circularization or banker‘s certificates and
- Statements received from suppliers‘ on balances outstanding

QUESTION SIX

a) You are required to differentiate between compliance testing and substantive testing

Compliance tests also known as tests of controls are procedures performed to obtain audit evidence about the effectiveness of the:

- Design of the accounting and internal control system i.e. whether it is suitably designed to prevent and correct material misstatements.
- Operation of the internal controls throughout the period.

The auditor carries out tests of controls to determine whether these controls have worked effectively throughout the financial period and can be relied upon to ensure complete, accurate and reliable accounting records.

on the other hand substantive tests are those tests on balances and transactions and other procedures such as analytical review, which seek to provide audit evidence as to the completeness and accuracy and validity of information contained in the records and or the financial statements. substantive tests are those tests carried out by auditors to confirm the assertions of the management i.e. existence, rights and obligations, occurrence, completeness, valuation, measurement and presentations and disclosure.

Substantive tests are of two types:

- Analytical review procedures and
- Tests of details.

b) You are required to explain the meaning of the following terms:

Teeming and lading

The misappropriation of cash remittances received form customers by using amounts from later remittance to fill the gap left by the earlier misappropriation. For example a cashier misappropriates cash takings in week one. The cashier then uses the cash takings in week two to make up exactly the shortfall from week one. The cash takings from week three are then used to make up the shortfall in cash takings from week two. It can be avoided by not allowing a cashier both to handle remittances received and to make entries in the customer accounts.

Audit trail

The audit trail is a record left by the accounting information system of movements in individual transaction data. This record, in the form of references to the processing of the data, provides a trail of the processing of transactions and other events entered into by the entity. Note that while some accounting information systems provide a visible and complete audit trail, others may provide an invisible and/or incomplete trail.

Depending on the accounting information system, the trail may start from the moment data about the event is first captured within the system to the time of its ultimate disposition in the financial statements. For example, the audit trail of a sales transaction may enable the tracing of the movement in data concerning the transaction from the time the order is placed by the customer until the time the transaction data is included in the appropriate general ledger accounts. The system records may also provide a link to other related transaction cycles. Continuing the example, the system may enable the linking of a particular sales transaction to related cash receipt transactions and inventory transactions. These related transaction cycles may have their own audit trail.

The accounting records in an accounting information system fall into four main categories:

- Source documents and other data capture records, such as customer order forms, sales invoices, journal vouchers, time cards, etc..
- Data accumulation records (or journals), such as daily cash receipt summaries, weekly payroll summaries, monthly purchases journal, etc..
- Subsidiary ledgers (or registers), such as accounts receivable ledger, plant and equipment register, etc.
- General ledger and financial statement records.

Capital commitment

A commitment is an agreement to perform a particular activity at a certain time in the future under certain circumstances. A capital commitment would therefore include instances where the company has committed to say purchase fixed assets or to purchase items requiring a significant cash outflow. Companies are required by the International Financial Reporting Standards to disclose in their financial statements, the amount of contracts for capital expenditure, so far as not provided for, and the amount of capital expenditure authorised by the directors which has not been contracted for.

c) You are required to discuss how you would verify the figure of capital commitments in a note to the financial statements

- The auditor should obtain a schedule of all capital commitments from management.;
- I will check the authorizations for capital expenditure in the board minutes before the year end to the schedule and I will note any items authorised in the board minutes which are not included in capital commitments;
- I will check purchase orders for capital equipment issued before the year-end and check that they are included in the list of items contracted for and at the correct value.
- Some items of capital expenditure may be in progress at the year end e.g. building a new factory. In this case I will check that the amount included in capital commitments is the total amount authorised less the amount included in fixed assets at the year-end;
- I will compare this year's capital commitments with the previous year and consider whether the change is reasonable. The value of capital commitments is likely to fluctuate, as it will be affected by the general level of capital expenditure and any major projects;
- The auditor should obtain a letter of representation from management to confirm that all commitments have been disclosed.

Based on this work I will conclude whether capital commitments are fairly stated in the financial statements

QUESTION SEVEN

a) You are required to identify situations when a sampling approach would be appropriate

- Where large populations exist, for example for organizations with numerous transactions or where there are many account balances within a class of transactions.
- Where the client has adequate internal controls. Where there are no controls it is impossible to use a sampling approach because of increased expected error.

- Population being tested must be homogenous in materiality. Where the population is not homogenous it is not possible to select a representative sample;
- Items must be separately identifiable therefore sequential numbering is essential. This will facilitate the sample selection process;
- Expectation of error must be low, i.e. that the internal control system must be reliable. Where the expected error is high it is not appropriate to use a sampling approach

b) Judgmental sampling

I) Judgmental sampling also known as non-statistical sampling

Involves using experience and knowledge of clients business and circumstances to select and test the sample without any mathematical or statistical tools. The auditor does not rely on probability theory and requires the use of judgment in making sampling decisions.

Advantages of judgmental sampling

- Its well understood and refined by experience;
- Opportunity to bring expertise and knowledge into play in selecting and testing sample units.
- No special statistics knowledge required. The auditor uses his judgment in making sampling decisions.
- No time wasted on the mechanics of statistical tools. More time is spent on auditing the sample units and less on the mechanics of constructing the sample and computing the mathematical implications of the results obtained.

Disadvantages

- Unscientific, it does not form a strong basis for defense, i.e., it is difficult to justify why one selected some items and left out others.
- Wasteful and large samples are selected. This is because in an effort to reduce the sampling risk the auditor attempts to select as many items as possible as opposed to statistical sampling where the size of the sample is precisely determined using probability theory.
- Samples may not be representative of the population and the results cannot be extrapolated to the population.
- Danger of personal bias in sample selection.

II) Random selection approach

Random sampling by use of random number tables or use of computers to select sampling units.

Advantages

- There is no bias in the sample selection. Judgement is not applied in sample selection;
- The sample selected is representative of the population because each unit in the population has an equal chance of being selected.

<u>Disadvantage</u>

The approach does not give the auditor an opportunity to apply judgment in sample selection. Exercise of judgment is an important part of the audit process that gives the auditor an opportunity to select items that will enable him to meet his audit objectives.

III) Systematic selection- in which the number of sampling units in the population is divided by the sample size to give a sampling interval. For example 50, and having determined the starting point within the first 50, each 50th sampling unit thereafter is selected. When using systematic sampling, the auditor will need to determine that sampling units within the population are not structured is such a way that the sampling interval corresponds with a particular pattern in the population.

Advantage

The approach eliminates bias in sample selection.

Disadvantage

The sample selected may not be representative of the population in circumstances where items within the population conform to a certain pattern. The selection of the nth item could therefore result in a sample consisting of similar items and therefore not representative of the entire population.

QUESTION EIGHT

a) You are required to explain the essential elements of the planning process of the audit of the financial statements produced through computerized systems.

Planning refers to developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.

- In developing the strategy the auditor would first need to obtain a good understanding of the clients business. To obtain this understanding the auditor will need to hold discussions with the management of the company, read relevant publications about the industry among other sources of information. This information will assist the auditor to identify potential risk areas that could affect the financial statements;
- Basing on the understanding of the client the auditor will need to determine the staffing requirements for the job. This involves determining how many people will be required on the job and their level of experience. It would also be important to determine the need for experts to assist in carrying out the job. At this point it would be important to evaluate whether there is need to involve IT experts in carrying out the job;
- Seeking to obtain an initial understanding of the client's accounting and internal control system. It is particularly important to identify the level of computerization of the operations of the company. This will assist the auditor in determining whether there is a need to involve IT experts and the approach to be adopted such as the need to use CAATS;
- The auditor should consider how a CIS environment affects the audit. Since the use of computers changes the processing, storage and communication of financial information and may affect the accounting and ICS employed by the entity, the auditor should consider how this will affect the audit procedures to be carried out;
- When the CIS are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risks;
- Formulating a job time table showing the planned commencement dates and the key deadlines to be met;

b) **You are required to identify eight items you are likely to find the director"s minute book**

It is important to note there are no standardized items that one would expect to find in a director's minute book. These vary from situation to situation but one would expect to find details of key decisions made in regard to the stewardship of the company.

- Details of authorization of purchase of key assets or to undertake key projects;
- Details of the approval of budgets and other forecasts;
- Details of the directors' assessment of the performance of the company;
- Any key appointments or resignations of key employees e.g. appointment of new directors;
- Key business decisions made such as approval of the business strategies to be undertaken by the company;
- Details of approval to obtain working capital financing such as obtaining and overdraft;
- Decisions to write off assets;
- Details of actions taken in case of reported fraud.

DECEMBER 2011

QUESTION ONE

a) You are required to discuss the purpose of a letter of representation

A letter of representations is a source of audit evidence normally sought from the directors at the concluding stages of an audit to confirm various matters stated in the accounts particularly those which concern questions of facts or judgment which are difficult for the auditor to prove objectively e.g. there is no need to obtain a letter of representation on the bank balance as this can be proved objectively but there is need to obtain a representation that all contingent liabilities have been properly stated because this is difficult to prove.

- Auditors seek a letter of representation in order to obtain written audit evidence on matters that are material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist (ISA 580 ‗Management Representations').

- Representations may be the only evidence, which can reasonably be expected to be available, but they cannot be a substitute for other audit evidence that could reasonably be expected to be available.

- The letter also ensures that directors acknowledge their collective responsibility for the presentation and approval of the financial statements. The letter is signed by those with knowledge of the matters concerned, on behalf of management.

- The letter also seeks to confirm oral representations made by management during the course of the audit and also provide corroborative audit evidence.

Auditors therefore obtain written representations from management on material matters where other sufficient appropriate audit evidence cannot reasonably be expected to exist.

b) You are required to explain the action auditors should take if the management refuses to provide a letter of representation.

Management maybe unwilling to sign letters of representations. If management declines the auditor should inform management that he will himself prepare a statement in writing setting out his understanding of any representations that may have been made during the course of the audit and then sends this statement to management with a request for confirmation that the auditor's understanding of the representation is correct.

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

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

c) **You are required to state the specific representations you, as an auditor, would wish to obtain from the management in respect of:**

(i) Assets.

For assets the auditor would be interested in obtaining confirmations from management that the asset in question exists and belongs to the company. For example if it is goods in transit the auditor may wish management to confirm that such stock belongs to the company. In addition the auditor may also request management to confirm that the asset is properly valued and all the necessary information has been disclosed. For example in relation to debtors the auditor may require management to confirm that they have created an adequate provision for any doubtful accounts or in-case of stock that the an appropriate provision for damaged stock has been created.

However, it is important to note that the specific representations required will depend on the specific asset. The auditor will ordinarily seek to obtain confirmation from management on issues that require judgment and that are difficult to prove objectively. For example on issues touching on the levels of provisions created such as provisions for doubtful debts or the accounting treatment accorded to contingent liabilities where management will need to make assumptions in estimating the possible losses.

(ii) Liabilities.

The main concern for liabilities is to obtain confirmation on completeness i.e. that all liabilities have been recorded and all the relevant information has been disclosed. This will mainly relate to liabilities that require the exercise of judgment such as contingencies. In case of contingencies such as litigations against the company, the auditor will require management to provide representations on the factors they have considered and assumptions they have made in deciding the accounting treatment adopted. The auditor will also require confirmation that management has disclosed all the contingent liabilities that existed as at the balance sheet date.

d) **You are required to identify any four contents of an audit engagement letter.**

The form and contents of an engagement letter may vary from client to client but would generally include:

- The objective of the audit of financial statements;
- Management's responsibility for the financial statements;
- The scope of the audit including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres;
- The form of any reports or other communication of the results of the engagement;
- The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is unavoidable risk that some material misstatements may remain undiscovered;
- That the auditor will have unrestricted access to whatever records, documentation and other information requested in connection with the audit;

- Details of other services to be provided such as taxation and management consultancy work;
- Fee - Basis on which it is computed, rendered and paid;
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit;
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

QUESTION TWO

v) You are required to write short notes on:

I) Audit risk

Audit risk means the risk that the auditor gives an inappropriate audit opinion. E.g. if the auditor reports that the financial statements show a true and fair view while in reality they are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

Audit risk = Inherent risk * Control risk * Detection risk

II) Inherent risk

This is the susceptibility of an account balance or class of transactions to misstatement that could be material individually or when aggregated with misstatements in other balances or classes of transactions assuming there were no related internal controls. Inherent risk could increase as a result of:

- An adverse attitude of managers to internal control matters;
- The type of business carried out;
- The environment within which the entity carries out its business;
- Where there is a high degree of estimation or judgement associated with the transaction;
- The entity is involved in very complex transactions;
- The assets involved are especially susceptible to loss or theft.

An assessment of inherent risk can be made by the auditor carrying out a review of these factors.

III) Control risk

Means that a material misstatement could occur in an account balance or class of transactions, which would not be prevented or detected in timely manner by the entity‘s accounting and internal control systems.
To assess control risk auditors should:

- Investigate and document internal control systems;
- Confirm their understanding of the systems by performing walk through tests. These are performed to ensure that the auditor‘s understanding of the client‘s accounting system is correct;
- Make an initial assessment of control risk based upon their understanding;
- Perform tests of controls to confirm their assessment;
- Reassess the level of control risk if controls are found to be ineffective.

IV) Detection risk

This is the risk that an auditor‘s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. This implies that detection risk is the only component of the audit risk model that is under the control of the auditor. The level of detection risk relates directly to the auditor‘s substantive procedures. The auditor‘s control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk to an acceptably low level.

b) You are required to identify the circumstances when it is appropriate to use only a substantive approach in an audit and when a combination of compliance and substantive tests should be used.

Generally it is more appropriate to use a combination of compliance and substantive tests as it results in an overall saving in audit time. This occurs when the client has sufficient staff to allow an effective system of internal control to operate (usually with proper segregation of duties which will prevent or detect fraud and error) and there a large number of transactions. In such a situation using a substantive approach will not be effective since the auditor will require to test a large volume of transactions, whereas the auditor can rely on controls to reduce the level of substantive testing.

It is not appropriate to check internal controls when they are weak, as checking these will only confirm that control risk is high, so performing compliance tests will be a waste of time. Internal controls may be weak in small organizations where there are too few staff for a proper segregation of duties. Also in small organizations the owner will operate the system of internal check, but usually there is no control over his actions and this will create a weak system of control.

In very small organizations it is not appropriate to perform compliance tests, as it is quicker to check all, or a substantial proportion of the transactions during the year.

For large organizations with proper controls in place, auditors usually rely heavily on internal controls, which allows them to perform limited substantive tests. This reduces the audit time, compared with undertaking only substantive tests, and thus results in a cost effective audit.

c) You are required to list four advantages and four disadvantages of using the risk-based audit approach when auditing the financial statements of limited companies.

Risk based audit approach is whereby the auditor identifies risks that could result in material misstatements in the financial statements of the client. It involves the analysis of overall audit risk into inherent risk, control risk and detection risk. The auditor formulates appropriate audit procedures that aim to address the identified risks. The auditor investigates the categories of audit risk so that more time is spent on risky areas and less on less risky areas.

Advantages of the approach

- It provides a framework for the conduct of the audit, it focuses auditor‘s attention on risk;
- The approach allows the development of effective and efficient audit programs and it develops an enquiring attitude of mind;
- The approach links into the concept of materiality, and the techniques of statistical sampling;
- The approach is helpful in identifying the areas where most work should be performed. It allows the auditor to spend more time in the areas of highest risk and less time in low risk areas, thus reducing the overall time for the audit or reducing overall audit risk. It

avoids excessive time being spent on low risk areas. For instance, in many businesses petty cash expenditure is small. Although the risk of errors and fraud in petty cash is relatively high, it is most unlikely that they will be material so audit work in this areas can be limited;

- By examining each significant item in the profit and loss account and the balance sheet the auditor is able to evaluate the level of inherent and control risk and consequently the amount of substantive testing required. This will ensure that only the required level of testing will be carried out.
- The audit is more effective because the auditor concentrates on key areas only;
- The approach enables the auditor to provide management with valuable feed back on the overall effectiveness of the design and operation of controls in managing the risks identified.

Disadvantages

- One major limitation of this approach is that frequently it is impossible to estimate the values of inherent risk, and to a lesser extent, control risk with any degree of certainty. If these elements cannot be determined accurately, then one cannot accurately determine the value of detection risk, which is required to achieve the overall level of audit risk;
- A further problem is that the auditor may assume that his assessment of control risk may apply to the whole system e.g. a sales system. However, there may be little or no controls over some parts of accounting system, so the control risk for these aspects of the system could be as high as 100%. For example in the valuation of the year -end stock and determining the doubtful debt provision, which may be carried out by one person. If there is no internal check over such items, it will mean that the control risk is high and so the auditor should perform more checks to reduce the level of detection risk and hence achieve the required level of audit risk;
- For the model to be useful the populations (i.e., numbers of items) involved need to be sufficiently large to allow for valid statistical conclusions to be drawn. This rules out the use of the model in many smaller audits;
- As is always the case with such models, there is a danger of adapting an overly mechanistic approach and that the auditor will lose his ‗feel' for the assignment.

From the discussion above, it can be seen that the audit risk approach is helpful in achieving an efficient and low risk audit. However, it is difficult to quantify accurately each of the risk elements.

QUESTION THREE

You are required to suggest ten practical control procedures that the owner of the retail hardware shop should implement to minimize possible losses through theft or fraud:

(a) Cash

- The shop should ensure that the persons dealing with cash are trust worthy, competent and well trained in their duties;
- Only specific persons should have the responsibility of receiving cash from customer. There should be clear reporting lines of these cashiers within the organization;
- An appropriate method of recording the cash collected should be put in place in the retail shop such as
  the use of cash registers to record the receipts or a computerized system that will be able to record the cash collected and issue a receipt to the customer;
- At the end of the day, cash count should be carried out by an independent person in the presence of the cashier. The physical cash should then be reconciled to the expected amount as per the cash register record. Any variances should be investigated;

- The cashiers should be supervised and surprise cash counts should be carried out by the supervisor;
- The cash collections should be kept in a safe;
- Money should be banked regularly, say on a daily basis by an independent person;
- Physical security measures such as employing guards should be put in place;
- The recording of the cash receipts in the ledger should be done by an independent person;
- Monthly bank reconciliations should be prepared.

b) Controls over stock

- An appropriate inventory system should be put in place. This should be able to capture all stock purchases and up date the stock balances with every sale made. All stock items should be appropriately coded;
- All stock purchases should be accompanied by a goods received note that is used by an independent person to update the stock records with the receipts;
- All issues of stock from the store to the shop should be authorised by a senior person and the stock movement up dated in the inventory system;
- There should be adequate documentation of all stocks returned back to the store or warehouse. The stock records should be updated with such returns.
- On a monthly basis a stock count should be conducted. The physical stock counted should be reconciled to the expected stock as per the inventory system;
- Closed circuit TV cameras should be installed to deter and detect shop lifting;
- Unauthorized persons should not be allowed into the shop premises;
- Security measures should be put in place to ensure that employees do not carry stolen items when leaving the premises; e.g. inspection locks etc.
- Stocks write offs should be authorised by a senior responsible official

QUESTION FOUR

a) You are required to briefly explain the meaning of the term "control procedures".

Control procedures are the detailed policies and procedures established by management within the control environment. Control procedures put together constitute an internal control system. For example the requirement that all purchase orders must be authorised by a senior responsible company official is an example of a control procedure. Control procedures are aimed at achieving a desired control objective. For example the above requirement that purchase orders should be authorised is an example of a preventive control aimed at ensuring that all purchase transactions have received the necessary approval which will assist in the prevention of errors and frauds.

b) You are required to discuss the importance of segregation of duties as a control procedure.

Segregation of duties refers to the separation of the various duties and responsibilities such that one person cannot process and record complete transactions from beginning to the end without being checked by another person. E.g. in the purchase of a company's fixed assets a single individual should not authorise the purchase, place the order, receive the asset and record the transaction in the accounting records, to minimise the risk of error and/or intentional manipulation of information.

Segregation of duties is important because:

- Helps detect errors in processing transactions. This is because the work of one individual will be checked by another. Errors made will be detected;

- Helps in deterring fraud. Segregation of duties would help in deterring people from perpetrating frauds. This is because the work of every individual is counter checked by another person.

c) You are required to List and briefly explain the substantive tests the auditor would carry out to verify the values attributed to:

(i) Trade debtors in a company's financial statements.

Substantive tests are the tests that the auditor carries out to obtain evidence as to the completeness and validity of the balances reported in the financial statements i.e. procedures carried out to test the management assertions.

In regard to debtors the following substantive procedures will be necessary:

- To carry out a trend analysis on the level of debtors by comparing the current year debtors with the previous two years and obtaining explanations for the reported trend. The evidence obtained from this analysis will assist the auditor in identifying circumstances that could lead to the misstatement of debtors balances;
- Compute the debtors‘ days, debtors‘ turnover and the ratio of provisions for doubtful debts to trade debtors‘ balances. Compare the ratios with the previous year and obtain explanations for any significant variations. Such an analysis will assist the auditor in evaluating the recoverability of the debtors‘ balances and whether an adequate provision has been made;
- Obtain a listing of balances as at the year end and agree the total to ledger balance;
- Select a sample of debtors‘ balances and perform circularization. This will assist in confirming existence of the balances;
- Obtain a sample of significant balances and verify if any payments have been received after the year-end. This will provide good evidence as to the recoverability of debtors balances;
- Discuss with management accounts that appear doubtful. This will include accounts above the authorised credit limits, accounts with disputed balances and balances that have been outstanding for a long period of time. Ensure that an adequate provision has been made for these balances;
- Test the operation of the cut-off procedures by obtaining details of the last dispatch note processed during the year and ensure that all transactions that relate to the current financial period have been recorded.

(ii) Trade creditors in a company's financial statements.

a) Compare the current years creditors balance with the previous year and obtain explanations for any significant movements. Such an analysis will give indications for example on the completeness on creditors.

b) Compute the creditors days and compare with the previous years and obtain explanations for any significant movements. Creditors days give an indication of the number of days it takes on average to pay creditors.

c) Obtain a creditors listing and verify that the total per the listing agrees with the total per the ledger.

d) From the listing select a sample of creditors and carry out the following procedures:

- Obtain or prepare a reconciliation of the creditors balance per the ledger to the suppliers‘ statements;

- Obtain explanations for all the reconciling items and where appropriate ensure that the reconciling items have been adjusted in the books of account. The reconciling items will mainly include suppliers invoices not posted in the clients ledger or payments not reflected in the suppliers statements.

e) Obtain a sample of payments made to suppliers after year- end and verify that all the invoices that related to the period under review had been accrued for.

f) Obtain all the pending invoices that relate to the financial period under review and verify that these had been accrued for.

QUESTION FIVE

d) You are required to explain how an audit firm may use third party confirmations to provide evidence in relation to six different balance sheet items.

One of the principal methods of obtaining corroborative evidence available to auditors is by inquiry. Inquiry involves seeking information from knowledgeable persons inside or outside the entity. Confirmation is the name given to a specific form of inquiry that is particularly widely used. It involves obtaining written confirmation from a third party, typically, although not exclusively, in relation to an account balance in which the third party has an interest. Confirmations can therefore be used for the following balances.

- Bank balance- the auditor can request the client's bankers to confirm the balance they are holding on behalf of the client as at the end of the year. This will confirm existence, completeness and accuracy;
- Debtors- by carrying out debtors' circularization. The replies will provide corroborative evidence to confirm existence of the debtor;
- Creditors- by carrying out creditors' circularization. The replies will provide corroborative evidence, completeness and accuracy of the creditor's balance;
- Investments (such as government securities, shares)- requesting a confirmation from the issuer of the instrument will provide evidence to confirm existence and accuracy of the investment balances. E.g. requesting the Central bank to confirm the amount of investments in government securities held by a client;
- Loans – requesting the provider of the loan to confirm how much they have granted the company and the terms of such facilities;
- Contingent liabilities – if the contingency relates to litigation against the company, the auditor could seek confirmation from the lawyers on the facts of the case and the likely outcome. This will assist in evaluating whether the contingency has been properly treated in the financial statements.

b) You are required to list two advantages and two disadvantages of using standardized audit programmes during audit assignments

Standardised audit programmes refers to where a firm has come up with standard audit programmes that provide the various audit procedures that are to be performed in the respective accounting areas. These are required to be applied when auditing the various clients.

Advantages

- Makes that audit efficient since there is no need to spend time in preparing new of audit programmes;
- Ensures that all issues are addressed in the respective accounting areas. The standardised programmes provide the minimum tests that must be carried out in

the respective accounting areas;

Disadvantages

- May stifle the initiative of the audit staff. This is because the need to exercise judgment in deciding the audit procedures to be carried out is eliminated;
- Some audit issues may not be addressed. This is because in following the standard audit programme some audit procedures that might have been necessary might not be carried out if they are not included in the standard audit programme.

c) You are required to identify four factors that should betaken into consideration by an audit firm when allocating staff to audit assignments.

- The level of experience and competence of the staff;
- Whether the staff is independent of the client;
- Whether the staff has appropriate training in the industry;
- The availability of the staff through out the duration of the audit.

QUESTION SIX

a) You are required to explain the meaning of the term "duty of care" in reference to the external audit assignment

What constitutes duty of care is not defined, however we can derive this from decided cases.

According to case law a duty of care exists where there is a special relationship between the parties. (Re: Hedley Byrne)

When carrying out his work the auditor must exercise care and skill. *As stated in Re:London and General Bank (UK case).* — An auditor is not bound to do more thanexercise reasonable care and skill in making enquiries. He is not an insurer, he does not guarantee that the books do correctly show the true position of the company's affairs, he must be honest, he must not certify that he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is truell

In the absence of suspicious circumstances, the auditor would not be liable for failing to uncover fraud and falsities which could not be discovered by exercise of normal skill an care. This was stated in *Re: City Equitable Fire Insurance (UK case).*

From these decided cases the duty of care refers to the responsibility that the auditor assumes towards the client and other third parties whenever they undertake an assignment. The auditor should carry out his work to the best quality standards possible to protect the interest of the parties who have appointed him.

b) You are required to explain the auditors' general responsibility. With regard to the prevention and detection of fraud and errors.

The responsibility for the prevention and detection of fraud and errors rests with the management of the entity.

The auditor on his part seeks reasonable assurance that fraud or error, which may be material to the financial statements, has not occurred or if it has occurred, the effect is properly reflected in the financial statements. The auditor should plan his work so that he has reasonable expectation of detecting material misstatements in the financial information resulting from fraud and error.

The auditor is and cannot be held responsible for the prevention of fraud and error. However, if the auditor comes across any fraud or error regardless of the materiality he should:

- Inform management as soon as possible;
- Carry out further procedures to confirm whether the fraud was an isolated case or indicative of others that had taken place;
- Evaluate whether the fraud could have an impact on his opinion.
- If the error or fraud is material the auditor should consider whether management has adequately disclosed the effect in the financial statements. If there is adequate disclosure there will be no need to modify the opinion. However, if the effect has not been disclosed in the financial statements the auditor should express a qualified opinion as appropriate.

c) **You are required to state and briefly explain five possible measures that auditing firms should take in order to avoid legal actions for negligence against them.**

The auditor can undertake the following steps to reduce potential liabilities for negligence:

- Undertaking measures to ensure that all assignments are performed to the highest quality standards. The auditor should ensure that the requirements of the International Standards on Auditing are adhered to in all assignments;
- Proper planning of the audit work to ensure that all potential risks that could affect the financial statements are identified and appropriate audit procedures performed;
- Putting in place appropriate quality control policies and procedures and monitoring their effectiveness;
- Limit access to his work or reports, where possible;
- Include a disclaimer of liability clause in the relevant document or report. Example of such a clause would be — while every care has been taken in the preparation of this document, it may contain errors for which we cannot be held responsible‖
- When submitting un-audited accounts or other un-audited financial statements (where the auditor prepares accounts on behalf of the client) the auditor should ensure that the purpose for which the statements or reports have been prepared is properly explained on the face of the report.
- Obtaining proper terms of engagement such that the auditor‘s roles and responsibilities are clearly laid out and the client understands his role in the engagement.

QUESTION SEVEN

a) **You are required to explain the factors that external auditors should consider in determining whether the financial statements of a limited company show a true and fair view.**

The auditor will have to consider whether the financial statements have been prepared in accordance with the provisions of the companies Act, the International Financial Reporting framework and any other relevant legislation and are free from material misstatements. In particular the auditor‘s opinion will be influenced by:

- Whether he has been able to obtain all the information and explanations that were necessary for the purposes of the audit. If the auditor has not been able to obtain to obtain information on issues that are considered material to the financial statements, this amounts to a limitation in the scope of the work and the auditor should qualify his report or issue a disclaimer of opinion;

- Whether the company has kept proper books of accounts. Management is required to maintain proper books of accounts, this include a ledger to record all the transactions, shareholders register and a record of minutes of the directors. If the company has not maintained such books of accounts then this would be a ground to qualify the reports;

- Whether the financial statements i.e. company's balance sheet and profit and loss account are not in agreement with the books of accounts and returns;

- Circumstances of disagreement for example where the auditor does not agree with the choice of accounting policy adopted by management or the mode of disclosure of facts in the financial statements;

- Whether there are unresolved inherent uncertainties such as conditions threatening the going concern ability of the company;

- Whether the financial statements have been prepared in accordance with the financial reporting framework.

b) You are required to identify six basic elements of the auditors' report containing an unqualified opinion on the financial statements.

The elements of the auditors' report include the following: (ISA 700)

- Appropriate title-The auditor's report should have an appropriate title such as ‗theindependent auditors report' to distinguish the auditor's report from any other reportsthat may be annexed to the annual report and financial statements.

- Addressee-The Auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations. Usually the auditors report is addressed to the members on whose behalf the audit is carried out.

- Introductory Paragraph-This identifies the Financial Statements audited including the date of and period covered by the financial statements. Under the Companies Act, financial statements or accounts consist primarily of the Balance Sheet, Profit and Loss account and notes to the account. International Accounting Standards on Cash Flow Statements requires auditors to recognize the Cash Flows as part of the Financial Statements;

- Paragraph on the scope of the audit-The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with the International Standards on Auditing (ISAs) or in accordance with relevant national standards or practices as appropriate. Scope refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. The auditor's report should describe the audit as including;

- Opinion Paragraph- The report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether they comply with the companies Act requirements.

  The terms used to express the auditor's opinion are ―give a true and fair view‖ or ―presents fairly, in all material respects‖ and are equivalent. Both terms indicate, amongstother things, that the auditor considers only those matters that are material to the financial statements.

- Dating the audit report- the auditor should date the report as of completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the report of events and transactions of which the auditor became aware ad that occurred up to that date.

- Auditor's address-The report should name a specific location, which is ordinarily the city where the auditor maintains the office that is responsible for the audit.

- Auditor's signature-The report should be signed in the name of the audit firm, the personal name of the auditor or both, as appropriate.

c) **Briefly explain the types of audit opinion that would normally arise from a limitation in the scope of an audit.**

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

Effect of a limitation in scope on the auditor's opinion

If the possible effect of a limitation on scope of an audit is material but not fundamental to the financial statements the auditor issues a qualified opinion (except for opinion)
If the possible effect of a limitation on scope of an audit is of fundamental importance that the auditor is unable to express an opinion on the financial statements, the auditor issues a disclaimer of opinion as mentioned above.

When there is a limitation on the scope of the auditor's work that requires the expression of a qualified opinion or disclaimer of opinion, the auditor should describe the nature of the limitation in his report and indicate the possible adjustments to the financial statements that might have been determined to be necessary, had the limitation not existed.

QUESTION EIGHT

a) **You are required to identify five ways in which information technology can be used to enhance the administration procedures and controls over an audit.**

- Cost budgeting -The firm's staffing requirements and planning can be performed using spreadsheets and individual audits can be costed and budgeted using integrated software;
- Word processing can be used for the routine production of reports, faxes, letters, memos, emails and other communications. It reduces the need for support staff and shortens the time in which documents can be produced, as the packages are user-friendly and can be used by professional staff.
- It can also improve client and staff relations, particularly where email can be used to eliminate the physical movement of large documents that need to be reviewed or edited.
- Use of word processing to produce audit programs, audit planning documentation, ordinary working papers, lead schedules, and almost all other current file documentation. Providing there is adequate backup and proper contingency planning, it may be possible to reduce the number of paper based files kept, with a consequent reduction in storage costs;

b) **You are required to identify five audit benefits that could be derived from**

using Computer Assisted Audit Techniques (CAATs) when carrying out testing of computer records.

- CAATs are likely to be the only effective way of testing programmed controls. Computer programs often perform functions without leaving visible evidence and the controls inbuilt in such systems cannot be tested manually. E.g. it is not possible to test the effective operation of passwords manually;
- CAATs are quicker and more efficient enabling the auditor to test a large volume of transactions quickly and accurately;
- Once acquired the use of CAATs is cost effective provided that they can be used in a large clients base;
- Use of CAATs and especially audit software enable the auditor to test the accounting system directly rather than relying on printouts which could be manipulated by the client;
- CAATs provide the auditor with additional options, there are certain audit procedures that can only be carried out through the use of CAATs.

c) **Briefly explain, giving an example in each case, five functions of an audit software interrogation programme.**

- File reorganization – enables indexing, sorting, merging and linking with other files;
- Data selection – enables data filtration
- File access- enables the reading of different record formats and file structures;
- Arithmetic functions – enables the performance of arithmetic functions;
- Selecting samples or items for testing e.g. selecting debtors accounts that have been outstanding for more than the credit period;
- Printing reports or letters in a format specified by the auditor.
- Detection of violation of systems limits e.g. a sales ledger can be checked to ensure no customer has a balance above the authorized credit limit;
- Testing reasonableness checks e.g. ensuring the value of purchases is not greater than the value of stocks received.

SUGGESTED SOLUTIONS

JUNE 2012

QUESTION ONE

a)

(i) Forming an Opinion

The main objective to enable auditors to express an opinion as to whether the financial statements give a true and fair view of the state of affairs of the company in question, and whether they‘ve been prepared in accordance with the applicable reporting framework.

(ii) Transparency

Audited financial information portray a positive image of an entity. It shows to the public what the entity is in existence for and the purpose of its activities. This reduces suspicion and improves relations with external entities.

(iii) Detection and Prevention of Frauds

Though not the principle objective of an audit the procedures set out by the auditor to achieve this objective highlights to management the weaknesses of the company‘s control system and puts on alert anyone who may have intention of defrauding the company.

(iv) Assistance in clerical accounting work and advice

The auditor should ideally not involve himself in the operations of the entity. He should not take any part of decision making and neither should he make it a primary concern to prepare the entity‘s financial statements. However, in the course of his work, the auditor could assist client staff in basic accounting functions and once in a while advice management on proper course of actions to take depending on circumstances in question.

b)

(i) Separate Entities

Over the years, the company, as a legal entity has come into existence. This is distinct from the owners (shareholders) of the entity (company) hence the objective in recent years has been to protect the interests of these shareholders. It entails reviewing the work of directors (managers).

(ii) Approach Shifting

The emphasis in approaching an audit has shifted from detailed checking of individual items towards an overall review of the systems in operation followed by an examination of the records and financial statements prepared thereof.

(iii) Computerisation

With emergence of technology, companies have embraced the use of computers. For an auditor, the primary objective is the same though he now has to understand the functioning of a computer, understand the client‘s computer information system, for him to carry out a good audit.

(iv) Auditor‘s legal position

With change in legal system, the auditor has been forced to assess his risk before taking upon himself any engagement, to reduce any liability as a result of loss suffered by third parties. This has made it an objective for an auditor to carry out a risk assessment with respect to a client‘s business.

(c)
While an internal audit function deals with appraisal of the internal activities through monitoring, examining and evaluating the adequacy and effectiveness of accounting and internal controls for management purposes, it may not be sufficient since the process is likely to be subjective. An external auditor is objective and comes in with more robust procedures to carry out the same appraisal, mainly for external reporting as well.

An internal auditor is answerable to management hence is more prone to manipulation to give a positive view. An external auditor is independent and his main concern is whether the financial statements are free from material misstatements.

The external auditor has sole responsibility for the audit opinion expressed and that responsibility is not reduced by an use made of internal auditing. All judgements relating to the audit of the financial statements are those of the external auditor.

QUESTION TWO a)

i) Preparation of Audit Report
It is the statutory responsibility of the external auditor to make a statement/report arising from his examination of the books of account.

ii) Stating explicitly
- Whether he has received all information and explanation which to the best of his knowledge is necessary for his report.
- Whether the financial statements portray a true and fair view of the company's state of affairs.
- Whether he has received adequate return submitted from branches.
- Whether the company has kept proper books of accounts.

All the above should be included in the Auditor's report.

iii) Call for confirmation
This would be with respect to;
- Whether the company's securities cover its bans adequately.
- Whether personal expenses have been charged to profit & loss a/c.

iv) Working papers
The auditor has the duty to prepare working papers and to avoid them to investigators investigating the company affairs.

v) Certification of financial statements
It is the auditor's duty to certify the profit and loss account and other financial statements in the company's prospectus and also when managing trustees resign.

b)
i. It is the directors' duty to prepare financial statements which show a true and fair view of the financial affairs of the company.
ii. They should ensure that these financial statements are prepared in accordance with recognized International Accounting Standards and guidelines.
iii. Ensure that the financial statements comply with the Companies Act as far as possible.
iv. The directors have a responsibility to maintain proper books of account required by the Companies Act. These include journals, registers schedules etc necessary to record all the transactions of a company.
v. They should ensure that the financial statements are in agreement with the underlying books of account.

vi. Ensure that the financial statements are timely availed to all users. This demands that they co-ordinate the accounting staff properly.

c) (i)

A letter of engagement is basically a statement issued by the auditor to his client preferably before the commencement of the audit to help avoid mis-understandings with respect to the engagement.

The letter documents and confirms the auditor‘s acceptance of the appointment, the objective and scope of the audit, the extent of auditor‘s responsibilities to the client and the form of any reports.

It enables the client and auditor know and understand their responsibilities. It also reminds management of their duty towards accounts and the internal control system.

It would be helpful to the auditor in case of supporting himself when charged with negligence.

(ii)

- When there is indication that the client mis-understands the objective and scope of theaudit or he issues new instructions.
- There is a revised or special term of engagement.
- When there is recent change in senior management, B.O.D or ownership.
- When there‘s significant change in nature and size of client‘s business.
- Legal requirements or enforcement of a new auditing guideline etc.

QUESTION THREE

a)

i. Carry out business of an entity in an orderly and efficient manner to satisfy the needs of different stakeholders e.g. shareholders.

ii. Ensure adherence to management policies. These policies provide one of the framework within which the internal control system operates.

iii. Safeguarding of assets. This could entail physical controls such as lock and key, documentation e.g. asset register. The auditor is interested in knowing that the client‘s assets have been subjected to safeguarding controls.

iv. Prevention and detection of fraud and error.

v. Ensure accuracy and completeness of accounting records.

vi. Ensure the timely preparation of reliable financial information.

c) With respect to transactions the following segregation of duties could be applicable:

i. Authorisation:

This function should be segregated such that different managers are given positions of authority depending on position in the organization, remuneration, qualification etc.

ii. Execution of Duties

This limits authority i.e. a person who authorizes a given transaction can not execute it that is carry it out.

iii. Custody of resultant assets

An official organizing a given expenditure shouldn‘t keep on asset arising from such an expenditure.

iv. Recording

This should be done by a person with sufficient knowledge and expertise and who is accorded powers to record transactions.

c)

i) Buying of goods

- Only goods/items that are needed by the organization are ordered for clearindication of type and quantity of each item should be shown.
- All orders should be made out of the company's order forms and signed by thepurchasing officer after verification from the manager of the requisitioning department.
- Purchasing of goods should be from authorized supplies, approved by theBoard for the given period.
- There should be controls to ensure all purchase invoices have been received andcorrectly entered in the books.

ii) Receipt of goods

- Goods should be inspect on receipt without delay to ensure that they all are thegoods which were ordered and that they are in good condition.
- Goods received note should be serially numbered and all numbers accountedfor by person independent of the receipt and ordering.
- Invoices should be checked against Goods Received Note before payment.
- A listing and evaluation of unmatched goods received enables unrecordedliability for goods taken into stocks, but for which no invoices have been received to be ascertained.

iii) Payment of Outstanding balances

- There should be schedule indicating creditors against duration of dues beforeauthorization for payments.
- Before payment, a responsible official in accounts department should approvethe invoices. This person should be independent of those responsible for any purchasing function.
- Before approving invoices for payment, the official should see that invoiceshave properly been initiated to him and evidenced that checking is complete.
- Cheques written to respective creditors should have been authorized by all thesignatories for transactions involving material sums of money.

QUESTION FOUR a)

i) Auditor's Intended reliance on systems of control

If the auditor has more assurance or intends to obtain more assurance from accounting and internal control systems, it means his assessment of control risk is low and for this reason a larger sample size will be needed. This is because the auditor needs to gather more audit evidence to support his assessment of control risk.

ii) Tolerable Error

This refers to the rate of deviation from the prescribed control procedure the auditor is willing to accept. The lower the rate of deviation the larger the sample size needs to be.

iii) Expected Error

This is the rate of deviation from the prescribed control procedure the auditor expects to find in the population. The higher the expected error, the larger the sample size needs to be so that the auditor can be in a position to make a reasonable estimate of the actual rate of deviation.

iv) Confidence Level Required by Auditor

The greater the degree of confidence that the auditor expects/requires that the results of the sample are in fact indicative of the actual incidence of error in the population, the large the sample size needs to be.

v) Number of sampling units in the population

This factor mostly affects small businesses, where population is likely to be small. For large populations, the actual size of the population has very little effect on sample size. However when population is small, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

b)

i) Sampling Risk and Non-Sampling Risk

Sampling risk is the risk that the auditor‗s conclusion, based on a given sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure i.e. either the auditor wrongly concludes that control risk is higher than it actually is or that a material error exists when in fact it does not.

Non-sampling risk refers to risks arising from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the sample size e.g. use of inappropriate procedures on the mis-interpretation of audit evidence.

ii) Tolerable Error and Expected Error

Tolerable error refers to the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved his audit objective.

Expected error on the other hand refers to the rate of deviation from the prescribed control procedure that the auditor expects to find in the population. This determine the sample size taken by the auditor i.e. the higher the expected error, the smaller the sample size.

iii) Audit Risk and Detection Risk

Audit risk is the chance of damage that may occur to the audit firm as a result of giving wrong audit opinion. This could be in form of monetary damages to client as compensation or loss of reputation.

Detection risk is part of audit risk and is the risk that an auditor‗s substantive procedures will not detect a misstatement in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

QUESTION
FIVE a)

i) There is need for an entity to keep abreast with bank transactions directly affecting this entity‗s operation. Bank charges and standing orders never get to reach the client‗s cashbook until a bank reconciliation is carried out.

ii) Uncredited deposits. Certain payments by customers using cheques will be recorded in the cashbook, but before the cheque reaches the bank, there will be inconsistent balances between cash book balance and bank balance hence a need for reconciliation.

iii) Unpresented cheques. These also need to be reconciled since the accounting year end may arrive before a certain cheque issued to a customer and credited as such in the cashbook, has not been presented for payment by customer for whichever reason hence inconsistent balances between entity‘s cash book and their bank.

iv) Direct Deposits. These are, for instance monies received by an entity through its bank account without prior notice. This receipt will thus not be reflected in the cash book until a bank statement is received when reconciliation can be done.

v) Bank reconciliation statements clear any misunderstandings between the entity and their bank since all transactions by both parties are accounted for in one statement for sake of clarity.

vi) Assist in the prevention of fraud. This is because, any discrepancy that causes mis-match between bank balance and cashbook balance will be thoroughly scrutinized, hence making it undesirable for one to commit fraud.

b)

Given the fact that a bank statement is an audit evidence from an external source, it‘s more reliable than if it were generated from within the entity. This is because an internal source of evidence is more likely to be distorted, intentionally or otherwise, than an external source of audit evidence.

A bank statement is in document form hence more reliable than if it were, say oral, since in the case of documents, references and confirmations can easily be carried out.

If the auditor directly makes an inquiry in writing, to the client‘s bank, then the bank statement would be a reliable audit evidence than if one of client staff was to do this.

However, internally generated audit evidence, say the bank statement was brought from a file in the client‘s office, would be reliable if the systems of internal controls were effective.

c)

i) Trade Creditors

- Obtain a schedule of the trade creditors with appropriate age analysis and check this with the control account of the creditors ledger.
- Review the individual accounts with the largest through put of transactions during the period.
- Debit and credit balances should be separated; debit balances should be included in debtors (grossing up(.
- Review the year-end cut-off procedures for purchases.
- Review the internal control over the purchases system which ensures that all goods received are properly recognized as liabilities of the entity.
- On testing individual balances that are suspicious, consider:
  Is the balance made up of specific items outstanding within a reasonable period?
  Have all the items been authorized for payment?
  Can the amount be reconciled with creditors statement?
- Perform analytical procedures on creditors, comparing age analysis with previous periods and creditors days.

ii) Specific provision for bad and doubtful debts

- For customers who are considered potential risks (hence provision made) review previous experiences with the particular debtor.
- To justify the specific provision, the debtor must exist, hence auditor should send debtors‘ circulirasion to the respective debtor(s).
- Carry out an age analysis for all debtors. Specific provision is made for long-standing debts.

- Review post balance sheet events to verify whether debtor paid hence need to cancel the provision earlier made.
- Check authority for making the provisions (specific)
- For debts considered risky, review the respective individual accounts of the customers and those that appear irregular by nature, composition or size of the balances or transactions therein.

QUESTION SIX

a) Error: it is used to refer to unintentional mistakes in financial statements, such as:
- Mathematical or clerical mistakes in the underlying records and accounting data.
- Oversight or misinterpretation of facts
- Misapplication of accounting policies.

An irregularity is a lack of compliance with set procedures and controls by either a staff or the management.

b)
Management/directors will first discharge their duties by setting up systems of internal controls (assuming non existed before). This should be consistent with policies laid down.

Directors should be the first to adhere to the Internal control system since the employees will do what the directors do with respect to the controls. Director: should thus ensure adherence to the internal control systems and ensure any new employee is made aware of this.

Directors should constantly review the internal controls to ensure they are being followed and in the event of any loop hole that could result in an error or irregularity, they should be made aware immediately so as to take the necessary steps.

Constant review and assessment of staff members should be done by management without notice. This will make staff to be alert and vigilant hence chances of errors will be reduced.

Directors should implement a thorough training session for new employees and emphasize the need for accuracy and competence in assignments and the need to comply with laid out policies.

Directors could reward competent employees, say with a promotion due to their astuteness and accuracy in their work. This will motivate other employees to follow the same, hence reducing possibilities of continued commission of errors.

c)
i. Knowledge of the Business. This entails getting information on general economic factors and industry conditions affecting client‘s business. Also ascertaining, important characteristics of the business is necessary.
ii. Understanding the Accounting and I.C.S: The auditor should find out to what extent he can rely on the client‘s internal control system.
iii. Risk and Materiality: The auditor should identify audit risk areas and inform his team about them. He should consider setting materiality levels.
iv. Nature, timing and extent of procedures: auditor should ascertain the possibility of change of emphasis on specific audit areas; time spent on the various audit areas should be budgeted for.

v. Coordination, Direction, Supervision and Review: Here, the auditor considers the involvement of other auditors in the audit of components e.g. subsidiaries. He'll also consider need for experts, staffing requirements and areas to visit.

vi. Terms of engagement: These should be formally recorded and agreed with the client.

vii. Extent of internal audit department involvement: The auditor would consider the degree of reliance on client's internal audit department.

viii. Effect of Accounting and Auditing Standards: Auditor should consider the effect of accounting and auditing standards on the audit work.

d)

i. Size and complexity of client's entity: The amount of audit work may overwhelm audit staff later on despite proper planning, as a result of increasing audit and verification procedures, need to visit all branches etc.

ii. Auditor's other assignments: the auditor could have two client firms with same calendar/accounting year ends hence he faces a problem of staffing.

iii. Lack of management support: If the support the auditor was expecting from management is not forthcoming, he may have to change the audit plan, say, seek alternative evidence. This may mess up his whole plan.

iv. High Control Risk: if material mis-statements are not detected by the internal control system, the auditor may form a wrong opinion or have to review all his audit procedures which is time consuming.

QUESTION SEVEN

a)

The purpose of an audit report is to reflect a clear written expression of the auditor's opinion on the financial statements taken as a whole. This entails indicating explicitly whether the financial statements give a true and fair view of the state of affairs of the company.

The auditors have a statutory duty to make a report to the members on the accounts examined by them and on the financial statements, at the A.G.M, during the period they hold office.

b)

i) Opening Paragraph
This identifies the financial statements of the entity that have been audited.

ii) Scope Paragraph
Indicating that all information and explanations necessary for the opinion were provided.

iii) Opinion Paragraph
That the financial statements presents a true and fair view of the operating results and financial position of the organization.

iv) Books of Account
That proper books of account were kept and these met the requirements of the Companies Act.

v) Financial Statements and Underlying records
That financial statements prepared reflect a true and fair view and agree with the underlying records including the books of account.

vi) Date of the report

vii) Auditor's address and signature.

c)

i) ‗Subject to' Qualification

This indicates that there are some material matters about which the auditor has reasons to disagree.

ii) ‗Except for' qualification

This indicates that there are some material matters which have quite significant effect and thus the financial statements give untrue information e.g. where no provision is made for doubtful debts.

iii) ‗Adverse' Qualification

Here, there is disagreement over a particular matter which is not only material but also fundamental. E.g. non-compliance of accounting principles.

iv) ‗Disclaimer' Qualification

Here, the auditor refuses to express any opinion. For instance where there is uncertainty regarding some item of financial statements or it is not possible to substantiate Cash transactions.

d)

(i) Limitation in the scope of the audit

This arises in a situation where in the auditor's duties have been compromised by the entity, e.g. where the terms of engagement specify that the auditor will not carry out an audit procedure he believes is necessary. In such a case, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

(ii) Emphasis of matter

This is a statement included in a note to the financial statements to highlight a matter affecting the financial statements. This statement does not affect the auditor's opinion. It would preferably be included after the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect. The matter could be with respect significant uncertainty about a going concern problem, the resolution of which is dependent upon future events and which may affect the financial statements.

QUESTION EIGHT

a) CAATs are procedures which are performed through a computer. The audit approach thus shifts from conventional to the use of computer system. Use of CAATs is governed by ISA 1009 and describes two of the main types of CAATs as:

1) Audit Software
2) Test Data

b)

The elements of the auditors' report include the following: (ISA 700)

- Appropriate title-The auditor's report should have an appropriate title such as ‗the independent auditors report' to distinguish the auditor's report from any other reports that may be annexed to the annual report and financial statements.

- Addressee-The Auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations. Usually the auditors report is addressed to the members on whose behalf the audit is carried out.

- Introductory Paragraph-This identifies the Financial Statements audited including the date of and period covered by the financial statements. Under the Companies Act, financial statements or accounts consist primarily of the Balance Sheet, Profit and Loss account and notes to the account. International Accounting Standards on Cash Flow Statements requires auditors to recognize the Cash Flows as part of the Financial Statements;

- Paragraph on the scope of the audit-The auditor‘s report should describe the scope of the audit by stating that the audit was conducted in accordance with the International Standards on Auditing (ISAs) or in accordance with relevant national standards or practices as appropriate. Scope refers to the auditor‘s ability to perform audit procedures deemed necessary in the circumstances. The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. The auditor‘s report should describe the audit as including;

- Opinion Paragraph- The report should clearly state the auditor‘s opinion as to whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether they comply with the companies Act requirements.

  The terms used to express the auditor‘s opinion are ―give a true and fair view‖or―presents fairly, in all material respects‖ and are equivalent. Both terms indicate, amongst other things, that the auditor considers only those matters that are material to the financial statements.

- Dating the audit report- the auditor should date the report as of completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the report of events and transactions of which the auditor became aware ad that occurred up to that date.

- Auditor‘s address-The report should name a specific location, which is ordinarily the city where the auditor maintains the office that is responsible for the audit.

- Auditor‘s signature-The report should be signed in the name of the audit firm, thepersonal name of the auditor or both, as appropriate.

c)

– Through sequence checking, it‘s possible to verify that all credit customrs dealt withover the accounting period are indeed in the debtors‘ control account since each debtor is sequenced.
– Summary processing. Here the totals of debtors balances are tested for completenessand accuracy by comparing them with the sum calculated in the control accounts.
– Record counts and cash totals will assist to verify whether the debtors balances in themasterfiles tally with final balances in the balance sheet.
– Verify accuracy and completeness of debtors transactions, say on a weekly basis by useof batch totals.
– Given the client deals with customers in transactions not exceeding a certain amount ofmoney e.g. Kshs. 100,000 at a go, programmed check digit verification could be used where a check digit is included in a reference number (the amount in figure) and is arithmetically checked to ensure it bears the required relationship to the rest of the numbers (amounts) and not any in excess.
– Programmed reasonableness checks to check whether there is any transaction with adebtor involving huge amounts of money that could be material.
– Programmed existence checks. Here customers would have codes to identify themuniquely hence this check ensures/verifies existence.

NOVEMBER 2004

QUESTION ONE

a) This is an audit carried out within the financial year, normally after six to nine months after the start of the financial period. The auditor carries out some audit while leaving the bulk of the work to be audited in a final audit.

The results of audit tests carried out during the interim audit form part of final audit, since they will be subjected to further tests at the final audit stage.

b)

i. Where the company is empowered by the Articles of Association to pay interim dividends, in which case the auditor will ascertain the company's interim performance for this purpose.
ii. Where it is a law requirement for a company to publish interim performance e.g. banks.
iii. Where an organization is operating in a volatile market and the owners wish to keep track of the interim performance.
iv. Where there is need to test the adequacy and compliance of the system of internal control.

c)

i) Cost
The audit process is made expensive especially for small firms, hence it may only be suitable for large companies with many transactions.

ii) Disruption
Interim audit may disrupt client operations since the auditor has to be attended to by client staff for information.

iii) Alteration of entries
Client staff may alter already audited figures before the year end.

iv) Unanswered questions
Questions posed at the interim audit stage may remain unanswered and this may distort final opinion as answers obtained later may not be of substance.

v) Inadequate diligence
Due to the fact that final audit will be performed anyway, the interim audit may not be done with the seriousness it deserves.

vi) Note-taking
Interim audits entail a lot of note-taking e.g. of interim balance carried forward or even budgeted performance figures to be used to facilitate final audit.

vii) Dependency Problem
Client staff may be dependent upon the interim auditing to solve their accounting problems which may compromise the objectivity of audit staff.

d)

i) **Proper Planning**
This will solve the problem of disruption since with proper communication between the directors and auditors, the audit process should not take much time.

ii) **Use of Journal Entries**
Alteration of entries should be done using journal entries which should then be listed for the auditor's attention.

iii) **Noting down questions**
Notes should be taken of any questions raised so that relevant answers can be obtained of a later date without loss of relevance.

iv) **Supervision by superiors**
The audit staff should be adequately supervised to solve the problem of inadequate diligence.

v) **Clarification of auditor"s responsibility**
This will ensure that client staff do not depend on auditor's work to solve their own accounting problems.

QUESTION TWO

a) With reference to guidelines issued by ICPAK, the following are the areas of risk that may compromise the work of an external auditor. The auditor needs to use the guidelines as references to avoid being unduly dependent on a single client;

i) **Fees**
Recurring fees paid by a client to an audit firm should not exceed 15% of its gross recurring income. Note the client should be a firm or a group of connected firms.

ii) **Beneficial shareholding**
An auditor should generally refuse an appointment by a client in which he has beneficial interest in shares and investments, amounting to 5% or more.

iii) **Loans**
An auditor should not make loans to or receive loans from a client.

iv) **Family & Other Personal Relationships**
An auditor should refuse appointment by a client in which an employee is closely related (connected with a partner or staff member in the firm).

v) **Undue Hospitality**
An auditor should instruct his staff not to accept goods or services from the client, unless they are availed at market prices. He should shum from excess generosity from the client.

vi) **Provision of other services**
The auditor can only provide services related to routine clerical functions or services of an emergency nature. He should not perform management functions to make management decisions.

vii) **Commission**
The auditor should not pay a commission to obtain a client, nor should his employees do so to obtain clients for him.

viii) Overdue Fees
Should overdue fees, aggregated with current assignment fees be significant enough to amount to a loan, the auditor independence could be jeopardized.

ix) Voting rights

Where a partner or staff owns shares in any capacity in an audit client, he should not vote at any general meeting in the company in relation to appointment, removal or remuneration of auditors.

b) **Statutory Matters**

- The firm should be a holder of a practicing certificate issued in accordance to section 21 of the Accountants Act.
- Ensure the firm is not disqualified to act as the auditors of the company under section 161 (2) of the Companies Act, that is:
  - The auditor is an officer of the company
  - The auditor is in employment of an officer or servant of the company.
  - The auditor/firm is a body corporate
- Ensure that all the auditors in the firm are legally and professionally qualified to act as auditors.
- The auditor should then request client permission to communicate with the previous auditors, to avail all the information to enable him decide whether his is prepared to accept nomination.
- If such permission is denied, the auditor should decline nomination.

Ethical Matters

- Auditor should check if the firm is related to the client in any manner that may endanger the firm's independence.
- He should check whether the firm has adequate resources in terms of skills and expertise knowledge necessary to service the needs of the potential client.
- Check the current commitments of the firm that may affect its ability to carry out the audit and complete it effectively.
- Check the risk exposures associated to the client as regards the firm's reputation.

c)

i) Right to access books of account and vouchers of the business at all times.

ii) Right to call for information and explanation which he/she considers necessary for purpose of forming an opinion.

iii) Right to attend the AGM regardless of whether accounts are a subject of discussion or not.

iv) Right to make a presentation at the AGM if:

- They were received too late for the company to send them to each shareholder to whom notice of the AGM was sent.
- A wrong impression was given to share holders by the Board of Directors about him.
- There is any material he wishes to add to his report, which came to his knowledge after the report had been dispatched but before the AGM. This does not include the right to make up for negligence earlier made in his report.

v) Right to indemnity

vi) Right to visit branches

vii) Right to information and explanation relating to activities of branches as far as they affect the company affairs.

viii) Right to remuneration

ix) Right to lien-hold on to his report until his fees are paid.

x) Right to legal and technical advice.

QUESTION THREE a)

i) In an organization, an internal control system enhances the efficient and orderly running of activities and operations to satisfy the needs of stakeholders.

ii) It ensures adherence to management policies. These policies provide a good framework within which the internal control system operates.

iii) Helps in the safeguarding of company‘s assets. Using physical controls such as lock and key and documentation e.g. fixed asset register, the company‘s assets can be safeguarded from unauthorized individuals.

iv) An internal control system assists in the prevention and detection of fraud and error.

v) It enhances accuracy and completeness of accounting records

vi) Ensures timely preparation of reliable financial information.

b)

Internal control system as discussed by ISA consist the following elements on components: -

(1) The control environment:: is the overall attitude, awareness and actions of directors and management regarding the internal control system and its, importance in the entity.

(2) Risk assessment process: this is risk management in the entity which is a component of inherent, control and detection risks i.e.

AR = IR X CR X DR

(3) Information system i.e. financial reporting which entails reporting of timely, accurate and complete information.

(4) Control procedures which are those policies and procedures in addition to the control environment which management has established to achieve the entity‘s specific objectives.

(5) Monitoring of controls: intend to see that I.C.S is operating as intended and whether any modifications are necessary e.g. supervision, evaluation etc.

c)

- Most internal controls tend to be directed at routine transactions rather than non-routine transactions.
- The possibility of circumvention at internal controls through the collusion of a member of management or an employee with parties outside the entity.
- There‘s also possibility of a person responsible for exercising an internal control could abuse that responsibility e.g. management.
- There is the possibility that procedures that constitute an internal control system may become inadequate due to changes in conditions, and compliance with procedures may also deteriorate.
- Lack of management support for the control systems due to their requirement that the cost of an internal control does not exceed the expected benefits to be derived.
- There is potential for human error due to carelessness, distraction, mistake of judgement and the misunderstanding of instructions.

QUESTION FOUR

a) Guidance regarding preparation of working papers and their importance fall under ISA 230: Documentation. Working papers basically refers to material prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit. Can be in the form of paper, film, electronic media or other media. These are important for the following reasons:

i) They assist in the planning of the audit. Current year's working papers will be used to plan subsequent years' audit.
ii) They assist in the supervision and review of the audit work. Audit assistants will use the working papers as evidence of work done.
iii) They assist incoming auditors to assess the position of the new client before they begin their actual audit work.
iv) Working papers record the evidence resulting from the audit work performed to support the auditor's opinion.
v) In the event of litigation against the auditor, the working papers will serve as evidence to prove work done by both an employee of an audit firm and the firm itself.
vi) Working papers minimize duplication of audit effort because whatever is done is documented and cannot be repeated.
vii) They are also useful in determining audit fees payable by the client as they indicate what has been done by whom and how long it took, all of which serve as a basis for charging.
viii) In the event of catastrophe, working papers will serve as material to support a plea for compensation by the insurance company.

b)

- The working papers should have a good index to facilitate referencing and cross-referencing.
- They should be as complete as possible. The working papers should include the auditor's reasoning on all significant matters which require the exercise of judgement, together with the auditor conclusion thereon. A competent auditor reviewing the papers should arrive at the same conclusion.
- In the event of difficulties, audit trainees should use the mnemonic facts as they know them at the time the conclusions were reached.
- Any symbols used by the trainees ought to be clearly explained.
- The audit working papers need to be updated periodically for evidence to be relevant.
- Audit working papers should be well secured.

c)

1. Information concerning the legal and organizational structure of the entity.
2. Extracts of copies of important legal documents, agreements and minutes.
3. Information concerning the industry, economic environment and legislative environment within which the entity operates.
4. Evidence of the planning process including audit programmes and any changes thereto.
5. Evidence of auditor's understanding of the accounting and internal control system.
6. Evidence of inherent and control risk assessments and any revisions thereof.
7. Evidence of auditor's consideration of the work of internal auditing and conclusions reached.
8. Analyses of transactions and balances.
9. Analyses of significant ratios and trends.
10. A record of the nature, timing and extent of audit procedures performed and the results of such procedures.
11. An indication as to who performed the audit procedures and when they were performed.
12. Letters of representation received from the entity.
13. Conclusions reached by the auditor concerning significant aspects of the audit.
14. Copies of the financial statements and auditor's report. Financial statements of previous years are also necessary.
15. Copies of bank mandates and specimen signatures.

d)

i) Standardised audit working papers enhance efficiency in the manner in which they are prepared and reviewed.
ii) They enhance training of audit assistance by following laid out audit programmes.
iii) They are also useful in the delegation of work to audit staff.
iv) They provide a means to control the quality of audit work.
v) Easy to use and follow out since they provide no room for judgement.

QUESTION FIVE

a) **Quantities**

- Obtain copies of count sheets used at the stock take.
- Ensure the stock sheet include the specific date when stock count was actually carried out.
- Check whether there were any post-count adjustments made to quantities of stock recorded in the count sheets.
- Ensure no repetitions of stock counts. This would be done by making sure no stock item appears more than once in any count sheet, hence count sheets should be indexed as well.
- Check with management in case there are some items of stock in the count sheets that are not physically present in the store at the time of audit test.
- Verify that steel components were not mistakenly counted as finished items.

b) **Identification of stock items**

- Comparing stock items in the stock sheets with the items of stock in the shelves/store.
- Verifying that stock items‘ description in the stock sheet match the actual stock item (as per given code) in the store.
- Ensure there is a clear distinction between finished units and steel components and that work-in-progress, if any is clearly identified.
- Verify that stock-in-transit is not included in stock count since it‘s not present at the store. This is recorded in purchases journal.

c) **Condition of Stock Item**

- Verify that stock whose value is given is in good condition i.e. there are no defects of any sort.
- Ensure that items identified as damaged or obsolete during the count have been treated as such.
- Obtain details of damaged/obsolete stock and the extent of damage as taken during the stock take.

d) **Cut-off Procedures**

- Verify that the value of stock as given is not inclusive of previous year‘s closing stock. This would entail ascertaining the value of opening stock (if any) and subtracting from this, the value of units produced in the current year.
- Check that no sales figure for finished goods (awaiting collection) is included into stock.
- Ensure that steel components ordered for, but not yet delivered (in-transit) from the suppliers, are recorded in the purchases journal in the appropriate period, and not as part of closing stock.
- From the duplicate book of stores ledger cards, obtain the last few (may be five) stores receipt forms recorded immediately before year end and trace to invoice to ensure the invoice is dated before year end.
- Verify that own material is not included as stock.

e) **Valuation of Stock**

- Check that the stock sheets used during the count are the ones used as the basis of valuation.
- Compare valuation sheets with copies of stock count sheets to ensure that no alterations were made or if so, this is reflected in valuation.
- Ensure costs allocated do not exceed net realizable value.
- Ensure costs allocated do not exceed net realizable value.
- Ensure items treated as damaged/obsolete in valuation really are damaged/obsolete.
- Check calculation of scrap on Net Realisable value and compare this with cost in respect of damaged/obsolete stock.
- Check for consistency in valuation method.

QUESTION SIX

a)

i) A voucher is a documentary evidence of a transaction as recorded in the books of account e.g. receipt, invoice etc. Vouching is the process of examining a voucher with the view of proving whether it has been properly authorized, recorded and that the amount is reasonable. Vouching audit thus means the examination of vouchers with the view of proving the true and fair view of the client‘s financial position of the business as at the balance sheet date. It‘s applied when the auditor feels that the internal controls of the client is not promising.

ii) Inherent Risk

This is part of the audit risk and is basically defined as the susceptibility of an account balance or class of transactions to misstatements that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

iii) Control Risk

Also part of audit risk and is defined as a risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and collected on a timely basis by the accounting and internal control systems.

iv) In depth Audit Tests

These tests are aimed at justifying the figures in the books of account, and eventually, in the final accounts themselves. The tests are designed for 2 purposes:

1. Support the figures in the account and
2. Where errors exist, to assess their effect in monetary terms.

Before embarking on these tests, it‘s essential to consider whether any errors produced by weak systems could lead to material differences.

b)

- Ownership: The auditor needs to verify that there was authority issued for the purchaseof an asset by the company.
- Cost: The auditor should verify the cost as given by comparing it with manufacturer ordealers.
- Valuation: This assurance will be acquired by ensuring appropriate depreciation has beencharged, so that valuation at year end is reasonable.

- Existance: By physically inspecting the assets, noting down their details.
- Presentation and Disclosure: Here the auditor analysis the classification of the assets,noting distinction between leased assets (if any) and fully owned assets as disclosed in the Balance Sheet.
- In the event of disposal, the auditor should verify issuance of authority to dispose,reasonability of disposal price and correct recording.
- Check receipt of the disposal price and proper recording in the records.

c)
- Purchase of a tangible fixed asset should be authorized by one person.
- Once acquired, there should be limited access to the asset i.e. only authorized personnelcan gain access or use the equipment.
- Ensure asset is kept in good condition, repaired if needed and consistent depreciationmethods applied.
- Ensure any transaction with respect to acquisition, disposal or modification of an asset isfully/completely recorded.
- Periodic comparison of recorded assets with existing assets.
- Ensure financial reporting frameworks and guidelines are followed in the disclosure andpresentation of assets.

QUESTION SEVEN

a)

i) **Peer Review**

This is a review of an audit firm‘s systems, procedures, and audit standards generally, conducted by another firm of comparable site and reputation. It‘s a review of a firm‘s complete set up by another firm and should be considered occasionally.

ii)

- Quality Control: peer review ensures a certain standard is achieved by an audit firm as a minimum, at least.
- Independence: The reviewing firm wants to confirm that the audit farm was working independent of its clients.
- Staff performance: To review the performance of audit staff and to assist them in improving their future performance.
- Weaknesses: To identify areas of weaknesses in the firm‘s procedures or applications thereof and to suggest solutions.
- Audit Opinion: To determine whether the scope and result of the audit work (audit evidence) is adequate to support the opinion as given in a particular audit.
- Industrial comparison: Review of a number of specially selected audits by the peer reviewers to check consistency of audit approach and application of a particular statement of standard accounting practice.

b)

By not providing for depreciation the management have gone against IAS 16 which require every non-current assets to be systematically depreciated over its useful life. If the directors think there is a change in the value of the plant and machinery, IAS 16 dictates that revaluation should be done by a competent and reputable person considering the market or fair value in an active market, then in the value have appreciated the carrying amount of the item should be changed to reflect the new value and depreciated over its useful life. Therefore the directors have no excuse for not depreciating the plant and machinery which have resulted in overstating the profit for the year and total assets of the company.

In an audit opinion I will qualify and include a ‗Expect for' paragraph by stating that the financial statements give a true and fair view except for the directors not depreciating plant and machinery.

ii) AUDITOR'S REPORT

Board of Directors,
Onyango & Sons L.t.d.
P.O. Box 29842 Nairobi,
City Square.

We were engaged to audit the accompanying balance sheet of Mount Elgon Ltd as of 31 October 2004, and the related statements of income, and cash flows for the year ended. These financial statements are the responsibility of the company's management.

We conduct our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation.

In carrying out the audit, we were unable to observe accurate physical inventories and due to limitations placed on the scope of our work by the accident.

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statement:

Omondi, John

23rd November 2004
P.O. Box 23497 NRB.

QUESTION EIGHT

a)
Auditors responsibility with regard to the prevention and detection of errors and frauds is as follows:-

(i) The auditor should remind directors of their responsibilities in prevention and detection of fraud and errors in the engagement letter or other communication and the need to have a system of internal control as a deterrent to errors and irregularities.

(ii) Property plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements, whether they are caused by fraud, other irregularities or errors.

(iii) Using professional scepticism in performing auditing to detect misstatement in the financial statements.

(iv) The auditor must obtain sufficient relevant reliable audit evidence to support his opinion. In regard to errors and irregularities he should have sufficient evidence that no material errors and irregularities have occurred or if they have occurred, then they have been either corrected and/or been properly disclosed in the financial statements.

(v) Conducting the audit using professional competence and exercising due care to protect the users of financial statements from fraud and error.

(vi) Other remedies include qualified report, disclaimer opinion, management letter etc if they get persistent frauds and errors in the accounts.

b)

(i)

- Personnel in charge of processing data are normally independent of those responsible for input and output, so as to maintain data integrity.
- Processed data is destined to the transaction or master file and nowhere else. From these files, their destinations can be verified.
- Transactions, once processed cannot be processed again or duplicated or improperly changed.
- Processing errors should be identified and corrected on a timely basis to avoid future unnecessary cost to rectify magnified problems.
- To ensure programs are not altered in any way, personnel in processing department should have no access to the programs.
- There should be recovery procedures for use in the event of power failure so that processing function is not left _hanging' as this creates room for manipulations.
- Provision of offsite processing in the event of disaster.

ii)

– Programmed sequence checking ensures the completeness of input in a timely fashion.Each item of input is verified as having been input into the system.

– Programmed matching of input to a control file, containing details of expected input.

– For accuracy, control techniques such as batch total will be used. This control alsoensures completeness.

– Programmed check digit verification wherein a check digit included in a referencenumber is arithmetically checked to ensure it bears the required relationship to the rest of the number.

– Summary processing. This technique ensures completeness and accuracy i.e. incomputation such as involving depreciation, calculation based on total assets value is compared with the sum of depreciation, calculation based on individual asset values.

– Record counts and hash totals are techniques used to ensure the continued correctnessof master files and the standing data contained therein.

– Programmed reasonableness checks (for input), including checking the logicalrelationship between two or more files.

– Programmed existence checks against valid codes.

MAY 2013

QUESTION ONE

(a)
Before Appointment

- The auditor should assess whether it has the adequate resources to carry on the audit to completion. This is in terms of staff available and timing of the client.
- The issue of independence should then be looked into i.e. is the firm related in any way with the client.
- The auditor should communicate with the previous auditor of the client to get some background information about the potential client before he can accept nomination.
- The auditor should ensure his appointment follows the proper channels i.e. Companies Act Cap 486

Letter of Engagement
On accepting nomination the auditor should communicate this to his client via a letter of engagement, outlining the scope of his duties.

The Actual Audit
The auditor should then obtain a list of all the books kept by the client, including the signatures of the officers who were in charge of them, and their signatures.

The auditor should then schedule an appointment with the relevant officer in the company e.g. the director, to discuss matters pertaining to the audit.

The auditor should then examine the accounting system and any weakness should be communicated immediately and corrective action taken.

Should there be a system of internal controls, the auditor should obtain a documentation of this and should set out to assess its strength or weakness.

The auditor should ask the client for a file of all vouchers in order of occurrence of transaction.

The auditor should obtain the Memorandum and Articles of Association, Partnership deeds etc. to assess whether the client‘s activities are in order as per the documents.

The auditor should prepare an audit programme so that he can start his audit work.

Carry out verification of Balance Sheet items.

Review the audit work.

Prepare the audit report.

(b)

- An auditor can only be removed by shareholders regardless of the party that appointed him.
- If any shareholder wishes to nominate another person in place of the existing auditor, he should give a special notice of 14 days to the company.
- The company would in turn send a notice to the retiring auditor within 14 days of the AGM.

- The retiring auditor would then have to send a written representation to the company. The company would then have to circulate the representation to shareholders provided that it is received in good time before the AGM.
- Nevertheless, if the representation cannot be sent to shareholders, the auditor will have to read them at the AGM.
- However if the representations are defamatory in nature then the company may refuse to send them to shareholders, especially so if the court is satisfied, on application of the company or any aggrieved party that the right representation have been misused or abused by the auditor. The court may order the auditor to pay expenses incurred by the company in this respect.
- The auditor being removed has the right to attend AGM, discuss his removal and also has equal right to speak at the meeting. This is to prevent directors from removing auditor without reason to the shareholders as to the reason behind his removal.
- If it is the first auditor of the company appointed by the directors to hold office until conclusion of the next AGM, such may be removed before expiry of his term of office, provided a notice of 23 days has been given to him.

(c)

Vouching

This is the process by which the auditor examines vouchers to see:-

- Whether these are for the business.
- Whether they have been authorized
- Whether they are for the current financial period.
- Whether they are properly recorded

This means that the auditor will try to substantiate the validity of information contained in vouchers representing the transactions.

Verification of assets and liabilities

This is done by scrutinizing the entries indicated in the balance sheet for:-

- Disclosure.
- Ownership.
- Value of assets.
- Existence.

Observation

This method is used to gather evidence concerning the company‘s procedures, operations, use and handling of assets. This is used in situations such as:-

- Mail opening
- Wages payment
- Counting of cash especially petty cash and cash in hand
- Stock taking

Enquiries and Third party confirmation

This is obtained either orally or in writing to parties who have had some dealings with the company to gather information about the accuracy of the company‘s own records e.g. from debtors, creditors, bankers and trustees e.t.c.

Re-Checking and Re-Computation

The auditor will have to re-check and re-compute the arithmetic accuracy of transactions e.g. in the Trial Balance, depreciation, taxation, goodwill and reconciliations, all of which must be recomputed before they are passed.

(d)

(i) "Except for Opinion"

The opinion is qualified by stating that the financial statements give a true and fair view except for the effects of any adjustments that might have been found necessary had the limitation not affected the evidence available to the auditors.

(ii) Disclaimer of Opinion

Occurs when the auditors conclude that they have not been able to obtain sufficient evidence to support, and accordingly are unable to express an opinion on the financial statements.

QUESTION TWO

(a)

The auditors are supposed to give an objective opinion regarding the financial statements at the end of their audit exercise. The auditor should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity. Independence of an auditor can be defined in the next paragraphs.

Independence of mind which is the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement allowing an individual to act with integrity and exercise objectivity and professional of scepticism.

Independence in appearance which is knowledge of all relevant information, including any safeguards applied to enable the auditors to give objective opinion.

(b)

- The auditor or any one closely connected with the firm should avoid accepting gifts in kind from the client or an officer of the client company, unless the value of the benefit is modest.
- Similarly, to strengthen independence, an audit practice or any one closely connected with it should not make loans to its client nor receive loans from clients.
- The auditor should be allocated free working space clear of management offices and only interacting with staff when necessary.
- The auditor should avoid unnecessary encounters with management outside office hours, unless the meeting is of an official nature, for as long as the auditor is the auditor of the client.

(c)

- In the event of the auditor having a relation in the client company, the auditor‘s independence may be jeopardized due to potential influence from the relative.
- The director(s) may insist in being overly friendly. This may put the auditor in a difficult position since he may not be in a position to handle his independence professionally.
- The auditor could be having some business relationship with the client whose accounts are being audited. His independence here is likely to be compromised.
- In the provision of other services to the client e.g. accounting services, the auditor may be faced with the challenge of not knowing how far to go, without putting his independence at a risk.
- Threatened litigation. Should there be a pending court case lodged by the client, for instance against the auditor, the auditor will be at a disadvantaged position as far as his independence is concerned.

(d)

- If he destroys any document, vouchers books e.t.c with a view to deceive any person.
- If he makes a false statement either in the Balance sheet, or any document. Vouchers or document with the view of deceiving another party.
- Where the auditor colludes with management to embezzle the client company money.

(e)

The auditor once hired by the shareholders has the obligation of carrying out his duties as per the contract signed and this involves protecting the interests of the owners of the company. He is to carry out his duties with the competence and independence required by his profession.

The auditor enters into a contract with the owners of the client company. This means that he is answerable to them for any matter connected with the audit of the client's accounts. He therefore owes the owners of the business(shareholders) a duty of care since he is expected to perform his duty with diligence.

QUESTION THREE

1. Where the auditor discovers that the client business is involved in criminal activities that may be harmful to society, e.g. terrorist activities.
2. In the event that the client company has not filed tax returns for a considerable period of time and management is not taking any steps to meet the requirement despite the auditor's recommendations.
3. In a legal suit filed against the auditor by the shareholders, the auditor has the right, in his defense, to give information about the company to his lawyer, in order to save his case.
4. If the auditor feels as if his life is in danger from third party attached to the client company, as a result of his audit work which may end up exposing the third party, he should report the matter to the police, giving detail about his relationship with the client.
5. The auditor has the duty to report the client to the local authority, if it is involved in dumping toxic wastes that may endanger the public. This is a step he will take if management is not responsive to his recommendation with respect to the same.

(b)

(i)

An audit committee is a panel of independent personnel in the client company that act as ‗watchdogs' over the company's auditing functions. They monitor the functions of the internal and external auditors and how management is implementing auditor's recommendations.

(ii)

- Evaluate the competence and independence of the external auditor, especially of the partner who is leading the team. This is important for instance when the auditor involves himself in assisting the client in preparing accounts.
- Probe to find out the nature and extent of issues management and auditors give considerable attention to. The committee should especially wary of the areas of conflict between management and the auditor.
- Address issues to do with hiring and firing of staff. In the event of management hiring former employees of the company's audit firm into key positions, the audit committee should look into the matter.
- Keep management on their toes when it comes to implementing the recommendations of both the internal and external auditors.
- Ask and receive frank assessment of the competence of the financial management team.

- Question and enter into discussion with management on key financial policies and the need, if any to alter or review the existing ones.
- The audit committee should be the champions of corporate codes of conduct.

(c)
A letter of engagement is a formal document issued by the auditor to the directors of a client company outlining the auditor‟s scope and nature of work that he is to undertake. The letter is meant to minimize misunderstanding between auditor and client. The letter of engagement also acts to educate the directors of the auditor‟s duties.

Contents

- The board‟s responsibility to prepare proper accounting records and financial statements which show a true and fair view and also comply with the Act .
- The auditor‟s responsibility to report on the financial statements and on the consistency of view of the directors‟ report.
- The scope of the auditors work.
- Matters relating to sending letters of weakness to management with respect to the systems of internal control.
- The need for a letter of representation from management.
- With respect to irregularities and frauds, the letter will include;
    1. The auditor‟s primary responsibility.
    2. The auditor‟s planning of his audit to have a reasonable expectation of discovering material misstatements in the accounts.
    3. Non-reliance on the auditor to uncover irregularities and frauds.

QUESTION FOUR

(a)

- The main function of an internal audit function is to find out whether the internal control system is working successfully or not.
- The internal audit function usually carries out consistent and regular reviews of the strength and weaknesses of the internal control system and this will act as a deterrent against perpetrators of frauds.
- This unit also advices management to put up appropriate controls to remove existing weaknesses in the internal control system and how to improve on the strengths.
- By reviewing the company‟s actual performance against the budget on a continuous basis, and the follow up of any significant variances, the audit function will highlight the possibilities of errors or frauds in the business, if these variances are unaccounted for.
- The internal audit function ensures that proper books of account are maintained.
- This unit will also be involved in setting up procedures for new areas of operations and thus help in sealing off any loopholes which can be used to perpetrate frauds.
- The unit will also follow up the recommendations raised by the external auditor hence keep management on toes about implementing them.

(b)

- The internal auditor can pinpoint to the external auditor the weak points in the systems of internal controls, thus enabling him to focus his attention only on critical areas rather than on the whole system hence save on time.

- The internal auditor can prepare internal audit working papers, review the accounting system, programs etc. on behalf of the external auditor hence when the latter comes, he need not write notes afresh.
- The internal; auditor can undertake the physical verification and inspection of fixed assets on behalf of the external auditor who will only come to crosscheck existing assets against recorded values.
- The internal auditor may be used to perform the following on behalf of the external auditor;
    1. Stock taking exercise
    2. Cash counts
    3. Branch visits
    4. Follow-up confirmation of debtors, creditors, bank balances e.t.c.

(c)

- **The internal auditor"s qualifications**. He should be a qualified end experiencedaccountant with experience in an auditing environment.
- **Past experience**. If the external auditor has had some prior relationship with theinternal auditor, he is in a good position to assess the degree of reliance on the latter‘s work.
- **Internal auditor"s independence**. The external auditor should first ascertainwhether the internal auditor did his work independent of management or perhaps his duties were compromised by pressure from management.
- **Conflict of interest**. If the internal auditor has some stake in the company‘s shares,then he may not be in a position to provide the external auditor with reliable, unbiased information.
- **Duration of service**. The external auditor should ascertain the duration the internalauditor has worked for the client company. If he has worked for long, he will be in a better position to provide relevant and reliable information to the external auditor.

(d)

Internal Control Questionnaire (ICQ)

This is a set of questions the auditor poses to his clients and require short answers e.g. ‗YES‘ or ‗NO‘. A ‗YES‘ answer indicates a strong internal control system and a ‗NO‘ answer indicates a weakness.

Flow Charts

These are diagrammatic representations of accounting function and procedures. The flowcharts reflect the movement of goods and documents from one department to another or movement of documents within one department.

System Notes

The purpose of the system notes is to describe and explain the system, while making any comments or criticism which will help demonstrate an intelligent understanding of the system.

Third Party Confirmation

These are confirmations from third parties e.g. debtors, creditors, bankers e.t.c. Any differences between these parties‘ replies and the company‘s own records may be a sign of weakness in internal controls.

Compliance Tests

These are tests carried out in the existing internal controls to see whether they comply with the design. Non-compliance indicates a weak internal control.

Substantive Tests

These are tests on the transactions to see whether they are correct. The tests can also be carried on the balances to see whether they are genuine e.g. for bank balances, request a bank to confirm the balance. Any difference with the company's cash book will indicate a weakness in internal controls.

QUESTION FIVE

(a)

- They are used as a basis for planning current year's audit.
- Through review of the working papers, the auditor can be able to control the current year's audit through a review.
- Working papers collected in investigating one part of the company's audit can be used for verification of another part.
- The audit working papers can be used as evidence of work done, in particular if the auditor has been sued for negligence.
- They can also be used as an accountability tool when each audit clerk has to give evidence of work done when questioned.
- Audit working papers are also used to assist in investigating the company's financial affairs.

(b)

- **Statutory material governing the conduct**, accounts and audit of theenterprise. These documents should be availed so that the nature of the business can be ascertained e.g. for a company, the Companies Act should be in the permanent file, for a partnership, a partnership deed would be necessary.
- **Rules and regulations of the enterprise**. This means Memorandum ofAssociation for a company or a partnership agreement for a partnership. These documents are necessary at any one time to settle any disputes should they arise.
- **An organizational Chart**. This shows the various departments and their heads.This information is important to ensure accountability in decision making.
- **Lists of books and other records** and where they are kept, names, positions,specimen signatures and initials of persons responsible for books and documents. This ensures certain people will be responsible in the event of their loss or destruction.
- **List of accounting matters of importance** e.g. accounting policies used formaterial areas such as stock, work-in-progress, depreciation e.t.c. This ensures consistency.
- **An outline history of the organization**. Special mention should be made ofthe history of the reserves, provisions, share capital and acquisition of subsidiaries. This verifies that the firm's finances are well managed within the proper legal framework.

(c)

- For cash purchases the auditor will need to include information such as copies of cash memos, bills etc. as supporting evidence of transaction carried out.
- For credit purchases the auditor will need copies of the day book, credit notes, and invoices for comparison with information collected from other sources.
- A copy of the purchases register for comparison with the above mentioned.
- Statements of confirmation from suppliers who will actually verify that they are being owed money for sales made to the company.

- To get an accurate figure for purchases the auditor would need a copy of the purchases returns day book, to verify the deductions from gross purchases.

(d)

- To ensure that shares and debentures were issued at the quoted prices and uniformly to all qualified allotees.
- Should there be forfeiture of shares at any one time, it should be clearly stated that defaulters were given adequate warning concerning monies owed.
- For contracts signed for capital projects, the auditor needs to ensure that ALL signatories actually appended their signatures to the contract.
- Verify that title deeds for land owned actually exists and clearly indicates the company as the legal owners of the assets as stated in the Balance sheet.

QUESTION SIX

(a)

(i) **Cash sales**

The following are the audit procedures that I would undertake in order to determine whether or not there has been any misappropriation of cash:-

i. Obtain analyses of cash balances and reconcile them to the general ledger: The auditors will prepare or obtain a schedule that list all of the client's cash accounts. For cash in bank accounts this schedule will typically list the bank, the account number, account type and the year-end balance per books. The auditors will trace and reconcile all accounts to the general ledger as necessary.

ii. Confirmation letters: send standard confirmation forms to financial institutions to verify amounts on deposit.

iii. Bank reconciliations: obtain or prepare reconciliation of bank accounts as of the balance sheet date and consider need to reconcile bank activity for additional montus. Also obtain a cut off bank statement containing transactions of at least seven days subsequent to balance sheet date.

iv. Cash count: the auditor should count and list cash on hand. Cash on hand consists of undeposited cash receipts, petty cash funds and change funds. Auditors should make a surprise count of these funds.

v. Analyze bank transfers for the last week of audit year and first week of following year to discover whether there is kiting.

vi. Investigation: investigate any checks representing large or unusual payments to related parties.

vii. Evaluation: evaluate proper financial statement presentation and disclosure of cash.

Credit Sales

- For amounts collected from debtors, the auditor should verify the counterfoil or the carbon copy of the receipts issued to customers.
- For large firms where transactions are voluminous, the receipts issued should be traced into the serially numbered cash book to check the correctness or otherwise of the entry.
- The auditor should the amount is entered on the same day of the receipt i.e. the dates of the receipt should correspond to the date on which the receipts are recorded in the cash book.
- For discounts allowed to customers, the auditor should ensure that the company policies regarding the same are followed and further authorized by the responsible officer.

(ii)

- The cashiers who operate cash tills must be properly trained and sincere to management.
- The activities of the operators should be checked and controlled by supervisor on duty.
- The cashiers should not be involved in preparation of ledger accounts. This practice reduces opportunities of committing ‗teeming and lading'.
- The cashiers should work in shifts then the supervisor on duty should remove the till roles to which the cashiers do not have any access. A new till roll should be inserted for the new operator at the start of a new shift.
- All cheques for payment should be signed by ALL the signatories before issue to creditors.
- The individual responsible for banking daily collections should be a person working in a department other than the cashiers. This reduces chances of collusion with creditors.
- At the end of every day, the cashier should be made to sign against the amount of cash she/he has handled- monies collected, banked and carried forward.

(b)

(i) **Petty cash balance**

- The auditor should verify that the petty cash float is not allowed to contain expenses supported by IOUs unless these have been authorized by a responsible official.
- Verify the use of petty cash control account in the general ledger.
- Verify that petty cash vouchers for which payment has been made bear the ‗paid' stamp.
- For substantial petty cash transactions, the auditor should check whether there are supporting documents attached.

(ii)**Revaluation Reserve**

- Whether the revaluation was carried out on assets that have actually in existence for a considerable period of time.
- In the case of land, the new value of land leading to the revaluation must have been certified by experts in the field i.e. land valuers and certificate of valuation availed to the auditor.
- The auditor should probe to find out more information where exorbitant amounts of money have been transferred to the reserve account.
- The auditor should check to find out the frequency of revaluation; revaluations carried out after every other year should be probed into.

(iii)**Copyrights**

- The existence of Copyrights should be verified by examining the actual copyright and it should be seen that the same has been duly registered.
- If the copyright has been purchased, the assignment should also be seen together with a receipt for the purchase consideration.
- The copyright register should be inspected to see that the copyright has been included therein.
- It should be verified that the copyright is carried in the books at cost less depreciation. The registration cost should form part of the cost while periodic renewal fee paid should be charged in the profit and loss account.
- Incase of joined registration of a copyright, registered assignment by the other party should be examined. The copyright may otherwise be subjected to litigation about its title.

QUESTION SEVEN

(a)

(i) Fraud

This term is used to refer to irregularities involving the use of criminal deception to obtain unjust or illegal advantage. For instance misappropriation of stock by the store-keeper, followed by altering of records.

(ii) Error

This refers to an oversight by a staff in the recording of a transaction, for instance an accountant, whereby an incorrect value for money is entered in the books unintentionally. In this case the intention of obtaining illegal advantage may not be the cause of such an oversight.

(b)

- The primary responsibility for prevention and detection of errors and irregularities rests with management
- This responsibility arises out of a contractual duty of care by directors and managers and also because directors and other managers act as stewards with regard to property entrusted to them by the shareholders.
- This duty may be discharged by them by instituting and maintaining a strong system of internal controls.
- The auditor is not required to assist the directors in the task the draft guideline does suggest that an auditor should remind the directors of their responsibility through an engagement letter or other means, and the need to have a system of internal controls as a deterrent to errors and irregularities.
- In regard to errors and irregularities, the auditor should have sufficient, relevant and reliable audit evidence to support his opinion or to conclude that no material errors and irregularities have occurred or if they have occurred, then they have either been corrected or properly disclosed in the financial statements.

(c)

- Consider materiality. If the matter could not be material in the context of the accounts then take no further action, but if material, appropriate action must be taken. Again if he matter is material, perform appropriate additional tests.
- If it appears that irregularities have occurred and may be material, then consider the effects on the financial statements and ensure that these have been prepared with such adjustments and amendments as may be required.
- If further investigation is required and the accounts cannot be delayed, then the auditor's report may have to be qualified for uncertainty.
- In the event where errors or irregularities have occurred, ensure that top management is aware of such events.
- Any weakness in the system of accounting and internal control which may give or have given rise to error or irregularity should be fully discussed with and reported to top management.

QUESTION EIGHT

(a)

- The auditor will have to gain an understanding of the programs to be tested otherwise he will not do a good job. This will call for some kind of training, which in consequence will affect the audit plan.
- The auditor will have to seek other means of following up transactions from initiation to final recording, since use of audit trail may not be practical.

- When evaluating the system of control, the auditor should avoid becoming too immersed in detail. He must obtain an overall view of the system, including the user-accounting staff and the computer department who maintain the payroll system. These are primary controls which cover completeness i.e. all input data is processed and accuracy.
- Having identified the primary controls, the auditor will know at which point the system controls is being established. In most cases, most of the work will be of clerical nature and that done by the computer is of secondary importance. In this case, it will be unnecessary to examine the program and system development controls in details and administrative controls will only become important if clerical controls are exercised in the computer department
- When the system of control is largely dependent on program control, it becomes necessary to review those in details and in addition to examine the system development and administrative controls so as to ensure that the program control have been designed and implemented correctly.
- Use of test packs: This consists of test data which will be processed in the same way as actual data. By using them in the payroll system, the program being tested will process normal data correctly and react correctly to deliberately invalid data.

(b)

- Issuing of passwords to the staff that process personal files will prevent other parties not concerned with the process from gaining access to the files.
- These passwords should be changed frequently since it is possible for others to crack the existing ones with time.
- Any update on the wage system e.g. to incorporate overtime rate should be authorized by a higher authority.
- Constant review of the personal files should be carried out to verify that only authorized alterations have been effected. This could be checked against the master file.

(c)

1. Checking authorization: Here, the auditor is only interested in verifying whether a certain entry was authorized or not, for instance whether a given pay increment was authorized before being effected in the payroll.
2. Checking output totals for reasonableness. Here, the auditor may compare the total salaries to staff between two or more periods.
3. Checking the output against source documents and clerical control totals.
4. Verifying consistency in the system of coding, for the various departments in the organization.

(d)

- Existence of ghost workers. In this case, there could be workers who've passed away but their names still appear on the payroll. Some party somewhere could be benefiting from the remissions without knowledge of the company.
- The absence of an audit trail may be a loophole for the accountants to embezzle some money and alter the programs to disguise the fraud.

CPA

AUDITING
DEC 2013 SUGGESTED SOLUTIONS

QUESTION ONE

a) In order to conduct an audit effectively and efficiently, an auditor should properly plan for the assignment.

i) Matters to be considered at the planning stage of the audit.

ISA 300 – Planning an audit of financial statements states that the auditor should plan the audit so that the engagement will be performed in an effective manner. Planning the overall audit strategy for the engagement and developing an audit plan

Matters to be considered;

✓ Knowledge of business
- General economic factors and including conditions affecting the entity's business
- Important characteristics of entity, its business, its financial performance and its reporting requirements including changes since date of prior audit
- General level of competence of management

✓ Understanding accounting and internal control systems
- Accounting policies adopted by the entity and changes in those policies
- Effect on new accounting and auditing pronouncements
- Auditing cumulative knowledge of accounting and internal control systems is the relative emphasis expected to be placed on tests of control and substantive procedures

✓ Risk and materiality
- The expected assessment of inherent and control risks and the identification of significant audit areas
- The setting of materiality levels for audit purposes
- Possibility of material misstatement, including experience of past periods or fraud
- Identification of complex accounting areas including those involving accounting estimates

✓ Nature, timing and extent of procedures
- Possible change of emphasis on specific audit areas
- Effect of information technology on the audit
- Work of internal auditing and its expected effect on external audit procedures

✓ Co-ordination, Direction, Supervision and Preview
- Involvement of other auditors in audit of components e.g subsidiaries, branches and divisions
- Involvement of experts
- Number of locations
- Staffing requirements

Other matters;
- Possibility that going concern assumption may be put to question

- Conditions requiring special attention, such as the existence of related parties
- Terms of engagement and any statutory responsibilities
- Nature, timing of reports or other communication with the entity that are expected under the engagement

ii) Ways of acquiring knowledge of business and industry
According to ISA 310 - Knowledge of business, such methods are;

- Previous experience with entity and industry
- Discussion with the people of the entity e.g. directors, senior operating personnel
- Discussion with internal audit personnel and review of internal audit reports
- Discussion with other auditors and with legal and other advisors who have provided services to entity or within the industry
- Discussion with knowledgeable people in the entity e.g. industry economists, industry regulators, customers, suppliers and competitors
- Publications related to industry e.g. government statistics, surveys, texts, trade journals, reports prepared by banks and security dealers, financial newspapers etc
- Legislation and regulations that significantly affect the entity
- Visits to entity's premises and plant facilities
- Documents produced by entity e.g.
  - ✓ Minutes of meetings
  - ✓ Material sent to shareholders
  - ✓ Material filed with regulatory authorities
  - ✓ Promotional literature
  - ✓ Prior years annual and financial reports
  - ✓ Budgets
  - ✓ Interim financial reports
  - ✓ Management policy manual
  - ✓ Manuals of accounting and internal control systems

The auditor can also consider;

i) General economic factors such as;
- General economic activity
- Interest rates and availability of financing
- Inflation, currency revaluation
- Government policies
- Monetary
- Taxation
- Tariffs, trade restrictions
- Fiscal
- Financial incentives

ii) Industry – Important conditions affecting client's business
- Market and competition
- Cyclical or seasonal activity
- Changes in product technology
- Business risk
- Adverse conditions as declining demand
- Key ratios and operating statistics
- Specific accounting practices and problems
- Environmental requirements and problems

- Regulatory framework
- Energy supply and cost

b) Before forming an opinion on the financial statements and deciding on the wording of the audit report, the auditor should conduct an overall review of statements
Audit procedures for final review

- **Accounting policies**

  Consider if they;
  - Are in accordance with generally accepted accounting principles and comply with fundamental accounting concepts as going concern, accruals, consistency and prudence.
  - Are acceptable to particular circumstances
  - Are commonly adopted in a particular industry
  - Are consistently applied over the years
  - Are consistently applied throughout the enterprise
  - Comply with all relevant accounting standards

- **Circumstances of enterprise**
  - Consider if the accounts are consistent with the auditor‘s knowledge of underlying circumstances of the business and information.
  - Review information in the accounts to determine if there are any abnormalities or inconsistencies

- **Presentation and disclosure**
  - Consider in any conclusion that a reader might draw from his reading of the accounts would be justified and is consistent with the circumstances of the enterprise
  - Consider if the substance of any transactions or activities is disclosed and not merely their form
  - Consider if the presentation might have been unduly influenced by management‘s desire to present facts in a favourable light
  - Consider if the review has indicated that there are few factors which might alter the policies used or the presentation of the accounts, and special attention needs to be paid to going concern difficulties.

c) Qualities of final accounts

i) That they use acceptable accounting principles which have been **consistently** applied and are appropriate to business

ii) The results of operations; income statement, state of affairs; Balance sheets and all other information included in financial statements are **compatible** with each other and with auditor‘s knowledge of enterprise

iii) There is adequate **disclosure** of all appropriate matters and the information contained in financial statements is suitably **classified** and **presented** e.g. a loan to subsidiary should not be described as cash at bank

iv) There is **compliance** with statutory requirements e.g. the Companies Act

v) There is compliance with other relevant regulations e.g. stock exchange regulations.

vi) There is compliance with accounting standards.

QUESTION TWO

a) Ways of minimizing auditor‘s potential liability for professional negligence.

- Stating in audit report the purpose of the report and that it may not be relied upon for any other purpose

- Advising the client in the engagement letter of the need to obtain permission to use the name of the accountant and withholding permissions in appropriate cases
- By limiting or excluding liability by a term in the engagement letter or third liabilities by a disclaimer in a report.
- By agreeing the duties and responsibilities in an engagement letter. This should specify the specific tasks to be undertaken and exclude specifically those that are not to be undertaken by the client and specify and limitations on the work to be undertaken
- By defining in their report the precise work undertaken, work not undertaken, any limitations to the work. This is so that any third party will have knowledge of the responsibility accepted by the auditor for the work done
- Identifying the authorized recipients of reports in the engagement letter or to third parties, by a disclaimer in the report
- Defining the scope of professional competence. The auditor should not undertake work that they are not competent to carry out
- By obtaining a professional indemnity insurance.

b) Defense available to an auditor in a court of law in case he has been sued for failure to detect fraud in client's company.

- Breach of contract may occur when there is non-performance of a contractual duty. Causes for action against the auditor for breach of contract may include but are not limited to the following
  - Violating client confidentiality
  - Failing to provide audit report on time
  - Failing to discover a material misstatement

- Remedies for breach of contract include requiring specific performance
  - Specific performance of contract agreement.
  - Providing for recovery of amounts lost as a result of breach. When specific performance or on injuction is not appropriate, the client is entitled to recover compensatory damages.

The auditor can use the following defenses against breach of contract

- The auditor proofs that the exercised dues professional care and skill in accordance with the contract.
- Contributory negligence was present i.e. both the client and the auditor were involved in negligence
- The client losses were not caused by the breach i.e. the client did not suffer financial loss as a result of auditor's negligence.

c) Duties of an auditor

- To report to the shareholders or directors on whether the financial statements of the company or group show a true and fair view or ―present fairly‖ and have been properly prepared in accordance with legislation.
- To consider whether the information in the management report included within the annual report is consistent with the audited financial statements.
- To form an opinion as to whether
  - Proper accounting records have been kept by the company
  - Such information and explanation as the auditors think necessary for the performance of their duties have been received from company's officers.
  - Report on any violation of law or company's constitution.
  - Make a ―statement of circumstances‖ when they cease to hold office for any reason.

QUESTION THREE

a) The auditor can use each of the following methods of sample selection when carrying out his audit assignment as follows

i) Stratified sampling

Stratification is used to reduce the degree of variation between items within a population and enables auditor to direct attention to those areas where there is the greatest potential monetary error. It has the effect of reducing sample sizes. Where auditors are concerned with discovery of overstatement errors and consider that the largest monetary errors are likely to occur in the largest individual populations, they will stratify population by value They may direct major part of their audit effort to those items with highest individual value.
Example;

Value	Number of items in stratum	Value of Stratum	Test size
Above Ksh.1m	10	Shs.36 million	10
Shs.250,000 to Shs.1m	150	Shs.95 million	50
Shs.50,000 to Shs.250,000	1000	Shs.93 million	50
Shs.10,000 to Shs.50,000	3000	Shs.60 million	35
Less than Shs.10,000	7000	Shs.15 million	15

ii) Cluster Sampling

It is useful when data is maintained in clusters (groups or bunches) as wage records are kept in weeks or safes in months. The idea is to select a cluster randomly and then to examine all the items in the cluster. The problem with the method is that the sample may not be representative.

iii) Horizontal sampling

It is simply choosing items subjectively but avoiding bias. Bias might come in by tendering to favour items in a particular location or in an accessible file or conversely in picking items because they appear unusual. The method is acceptable for non-statistical sampling but is insufficiently rigorous for statistical sampling.

iv) Block sampling

It is simply choosing at random one block of items e.g. all June invoices. It consists of selecting a number of adjacent transactions or items e.g. all sales in a particular week or all credit customers with a name beginning with a particular letter. It is not an appropriate selection method since populations might be expected to be structured in such a way that items in a sequence have similar characteristics to each other but different characteristics to items elsewhere in the population.

b) An auditor is not required to carry out a complete check of all transactions and balances;

i) Economic

The cost in terms of expensive audit resources would be prohibitive which will inflate audit fees

ii) Time

The complete check would take so long that the client may receive audit reports on matters which are outdated

iii) Practical reasons
Users of accounts do not expect 100% accuracy. The auditor will only focus on material areas.

iv) Psychological
A complete check would be tiresome to audit staff who may then not carry out an effective and efficient audit

v) Fruitless/End results
A complete check would not add much to worth of figures if as would be normal a few amounts were discovered. This emphasis in auditing should be on the completeness of record and true and fair view.

vi) Large volume of transactions
For large business with voluminous transactions, it is necessary for auditor to sample since not all transactions can be audited. Full testing would not achieve the specified audit objectives for an area e.g. full testing on sales invoices would not verify all sales are recorded (it may not demonstrate completeness) nor would it deal with human error on the part of the auditor.

c) Cases where an auditor is required to conduct a complete check of all transactions and balances
- Categories which are few in number but of great importance e.g. land and buildings
- Categories with special importance where materiality does not apply e.g. director‗s emoluments and director‗s loans and any other such benefits.
- Unusual, one-off or exceptional items
- Any area where the auditor is put upon enquiry
- High risk area
- Audit area does not consist of items of the same kind, i.e. there is non-homogeneous population.

d) Importance of considering materiality in selecting sample size
- An auditor is not required to have confidence that all items in a set of accounts are 100% correct. His duty is to give an opinion on the truth and fairness of the accounts. Errors can exist to accounts and yet accounts still give a true and fair view. The maximum error that any particular magnitude can obtain without marring true and fair view is tolerable error. Tolerable error is auditing materiality.
- In his audit planning, the auditor needs to determine the amount of tolerable error in any given population and to carry out tests to provide evidence that the actual errors in the population are less that tolerable error.

QUESTION FOUR

a) Purpose of internal control questionnaire to an auditor
It is a form of recording internal control system. It is regarded as document for evaluating rather than recording the system. It consists of objective questions which focus on some specific controls and information obtained in completing the Internal Control Questionnaire used to answer relevant internal control evaluation questions.

Objectives/uses of internal control questionnaires
- Ascertain a client‗s system of accounting and internal control
- To record client‗s system
- Identify controls or absence of controls

- Assist the evaluation of the system
- Enable the auditor to review and assess adequacy of system
- Enable auditor to design a series of tests hence draw up the audit programme
- Enable audit staff to familiarize themselves with the system quickly and comprehensively

b) Factors to consider when determining adequacy of the internal control system

i) Segregation of duties

- No one person should be responsible for recording and processing of a complete transaction. There should be different staff for recording, processing, authorisation and approval of the transactions.
- Involvement of several people reduces risk of intentional manipulation of accidental error and increases the element of checking of work

ii) Physical control

Concerns physical custody of assets and involves procedures designed to limit access to authorized personnel only

iii) Authorisation and approval

All transactions should require authorisation or approval by an appropriate person. Limits to authorisation should be specified.

iv) Organisation controls An enterprise should have

- Plan of organisation that defines and allocates responsibly.
- Every function should be in charge of a specified person – the responsible official

v) Delegation of authority and responsibility clearly defined. An employee should always know the precise powers delegated to him, the extent of his authority and to whom he should report to.

vi) Supervision.

All actions by all levels of staff should be supervised. The responsibility for supervision should be clearly laid down and communicated to person being supervised.

vii) Management

These are controls exercised by management which are outside and over and above the day to day routine of the system. They include overall supervisory controls, review of management accounts, internal audit and budgeting.

viii) Control of Documents

Sensitive documents i.e. receipts, local purchase orders etc should be handled by reliable person. They should be pre-numbered to ensure control.

ix) Personnel

Company should employ qualified and experienced people

x) Arithmetic and accounting accuracy

This ensures that accuracy of transactions through paper recording by use of calculators and computers. These are controls in recording function which check that the transactions have been authorized, that they are all included and that they are correctly recorded and accurately processed.

c) Kenya Cans Ltd.

i) Weaknesses in the system

- Lack of supervision.

  There is no authorized employee to monitor and supervise the employees as they place scrap metal in large bins outside the workshop. The scrap metal is therefore prone to theft by staff

- Lack of authorisation controls

  There is no staff to authorize the local scrap dealer when collecting the scrap metal from the bin.

- Incomplete recording system

There is no staff recording the scrap metal on being collected by local scrap dealer. Company is prone to losing income from scrap metal

- Collusion between gate keeper and scrap metal dealer

There is not staff to monitor the gatekeeper while weighing the scrap before it leaves the factory. The dealer is likely to collude with the dealer to conceal some income and defraud the company.

- Lack of accounting documentation

There is no recording system over scrap metals collected by dealer. The dealer is likely to deflate the cheques sent thereby defrauding the company of the income from sales.

- Collusion between scrap metal dealer and company cashier

There is no approval, authorisation and monitoring controls over the amounts received from dealer. Cashier is likely to collude with dealer to defraud company income.

ii) Recommendations

- An efficient recording system to ensure proper documentation and scrap metal sales
- An upto date report on scrap metals sales on a monthly or weekly basis
- A specific qualified competent accountant positioned at the gate to monitor processing of the weighing and recording of scrap metal safes
- An upto date technology to be implemented for recording and weighing scrap metal
- A proper supervisory control system to ensure that gatekeeper, scrap metal dealer and cashier are supervised.
- Segregation of duties. There should be different staff for weighing scrap metal, recording and receiving cheques
- Confirming amount and recording in cheques

QUESTION FIVE

a) Audit assurances in the audit of stock

- Whether a continuous inventory is maintained. There should be at least annual stock take
- Control over stock documents. Documentation should be considered by use of pre-numbered forms with regular sequence checks
- Controls over receipt of goods
- Storage conditions for stock
- Safeguarding of stock against loss, fire, deterioration due to poor storage
- Recording system. Stock records should be continuously compared with actual stocks held by independent officials
- Valuation per IAS 2 i.e. lower of cost and not realizable value
- Existence of stock
- Completeness of stock records

- Presentation and disclosure of stock in financial statements.
- Whether the company has rights and obligation over stock recorded.

b) Audit procedures for stock balances in Balance Sheet

- Enquire into what costs are included, how these have been established and ensure that overhead addition is based on normal costs and is reasonable in relation to information disclosed by draft financial statements.
- Test check price on inventory, lists with official sales list bearing in mind any trade discounts which are normally granted off the list prices
- Ensure that inventories are valued at net realizable value if this is less than cost. Check if the relevant party processed inventories and raw materials have also been written down
- Following up any items which inventory records show are more than say 6 months in inventory. Enquire into the reasons for this and ascertain the possible realizable value of such items.
- Follow up any inventories which at the time of selling of product lines at less than usual selling prices e.g. due to completion, or substitute products on the market
- Follow up valuation of all —second‖ items and ensure that they are valued at reasonable estimated net realizable value is less than cost
- Check re-order levels, check whether all stock items are subjected to a maximum or minimum stock levels
- Compare actual stocks held by independent officials with the stock records. All differences should be corrected and investigated
- Check on storage conditions which deter deterioration due to physical access e.g. heat, cold, microbial action.
- Check whether a continuous inventory is maintained. There should be at least an annual stock take
- Check procedures established for stock take
- Check procedures for identifying damaged, slow moving and obsolete stock and cut off procedures
- Check the purchases records to ensure completeness of stock records
- Check whether stock has been valued at lower of cost and net realizable value as per IAS 2
- Physically inspect stock in premises to ensure that closing stock figure actually exists.

c) Bar coding

It is a form of identification for all the products in the supermarket. Each product has a bar code number to identify it from other products. The product bar code number is read by the bar code reader so as to identify the product and its price.

Importance of bar coding

- To identify each specific product
- To identify the price of each product
- To save supermarket on costs of attaching price tags to each product.

QUESTION SIX

i) Kimani and associates

i) Key risk areas in government procurement system

- Fraudulent payments to suppliers
- Excessive fees for goods and services procured
- Inaccurate payments for goods and services
- Delays in paying for purchases resulting in damage to government reputation
- Breach of regulations, legal or company requirements

- Collusion between government procurement officers and suppliers for fictitious payments.
- Inflated prices for goods and services through collusion between suppliers and government procurement officers
- Payment for goods that were never ordered and delivered
- Non-compliance to procurement processes and procedures
- Lack of clearing defined procurement policies, processes and procedures
- Complex procedures not communicated to relevant procurement officers

ii) Possible measures to improve procurement system.

- Establish policy and procedures for procurement
- Policies, procedures for procurement properly communicated at all levels of management
- Set authorisation and approval procedures for procurement with different levels covering different cost levels
- Procedures for negotiating the best deals in the market place for a place for specific bulk purchased
- Set up of a dedicated procurement section in which case all procurement requests should be made through this unit to maximize the benefit of any negotiated deals
- Have an approved list of suppliers, ensuring that no purchases made outside of that list without authorisation
- Effective payment procedures
- Exception reports showing where transactions have not been authorized, where they fall outside of the established procedures.

b) Audit procedures for audit of liabilities

- Obtain a schedule of payables, with appropriate age analysis and check this with the control account and purchase ledger
- Separate debit and credit balances, debit balances being included in receivables. This is called grossing up
- Review the individual accounts with the largest throughput of transactions during the period – not necessarily the largest balances at the end of the year
- Review year end cut off procedures for purchases
- Review internal control over purchase system which ensures that all goods received are properly recognized as liabilities of the company
- Select a sample of supplier balances which should be based on the reciprocal of purchases turnover in which case monetary sampling unit should be used.
- Check whether all the liability balances are made up of specifications outstanding within a reasonable period
- Check whether all items have been authorized for payment
- Agree the liability amounts, reconcile with supplier statements
- Consider the need to perform a circularization of accounts payable, seeking direct confirmation of amounts due
- Review payments to payables and other liabilities just after the year end
- Perform analytical procedures on payables, comparing age analysis with previous periods and payable days.

$$= \frac{\text{payables}}{\text{cost of sales}} \times 365$$

QUESTION SEVEN

a) An auditor should form an opinion on the adequacy of the accounting treatment of an inherent uncertainty disclosed in the financial statements of a company.

i) Inherent uncertainty

A limitation in (or on) scope gives rise to doubt i.e. uncertainty about the ―true and fair view‖ because it necessarily means that there is insufficient relevant and reliable evidence on which to base the audit opinion. However, this has nothing to do with ―inherent uncertainty,‖ this is quite contrary.

There are some matters for which the auditor will have all necessary i.e. sufficient and appropriate i.e. relevant and reliable, information that can be reasonably expected to be available yet still be unable to form an opinion on it because the nature of the matter is inherently uncertain i.e., it concerns future outcomes.

Hence, going concern and ‗pending litigation' are the classic examples of inherent uncertainty, the auditor cannot reasonably expect to know what the verdict of a jury might be in a court case to be held months or fears into the future.

ii) Treatment of inherent uncertainty in audit

Uncertainty applies to the outcome of a financial statement item that is not susceptible to reasonable estimation prior to the balance sheet date. It is another way of saying that notwithstanding the procedures carried out, the auditor cannot obtain reasonable assurance as to how fairly stated an item is. This is usually the case as regards the outcome of court case awards or a client who is heavily reliant on obtaining a key contract or renewal of financing to continue operating as a going concern.

Uncertainties differ from accounting estimates in that accounting estimates are capable of reasonable estimation by management in the preparation of financial statements. An uncertainty may relate to the outcome of a lawsuit, the results of tax authorities audit, serious deficiencies in working capital, or failure to comply with the terms of a loan agreement.

In determining whether the financial statements are presented fairly, the auditor should evaluate the materiality of reasonably possible losses, both individually and in the aggregate, upon the resolution of the uncertainties. The auditors' consideration of materiality is a matter of professional judgement and such judgement and such judgement is made in the light of surrounding circumstances. In some cases, uncertainties relate primarily to financial position, whereas others more closely pertain to results of operations.

Emphasis of matter with an unqualified opinion

Any uncertainty may result in adding an emphasis of matter to the standard report when;

- There is a probable chance of material loss and management has not made an accrual in the financial statements
- There is a reasonable possibility of a material loss and
    - The amount of the possible loss exceeds the auditor's judgement about materiality, and
    - The likelihood of occurrence is closer to probable than remote

The explanatory paragraph should describe the uncertainty and indicate that its outcome cannot be determined because it depends on future events. As shown below, the explanatory paragraph should follow the opinion paragraph. In this example, the explanatory paragraph is shortened by reference to the note in the financial statements. There is no mention of the uncertainty in the other paragraphs of the report.

Independent auditors report

(First three paragraphs same as the standard report)

As discussed in Note X to the financial statements, the company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are I progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

Other types of opinion

Uncertainties will result in expressing other than an unqualified opinion when there is a scope limitation. A scope occurs when sufficient evidential matter does (or did) exist during the audit to support management's assertions about the uncertainties. However, such evidence was not availed to the auditor because of management's record retention policies or a client imposed restriction. For a scope limitation, the auditor should express a qualified opinion or a disclaimer of opinion. The departures from the standard report are the same as described earlier for other scope limitations.

b) Contents of directors responsibilities
- Ensuring that proper books of accounts are maintained by company
- Ensuring that the financial statements as income statement, Balance sheet and cashflow statements have been prepared in accordance with identified relevant reporting framework e.g. international Accounting Statements.
- Timely preparation of financial statements
- Designing an internal control system
- Implementing internal control system
- Ensuring accuracy, completeness of financial statements
- Designing appropriate accounting policies and procedures e.g. for depreciation
- Ensure that accounting policies adopted are consistently applied from period to period
- Ensure that any departure from reporting framework is properly reflected, disclosed in financial statements
- Ensure uniformity in application of International Accounting Standards and accounting policies
- Ensure that they inform the shareholders of the contents in financial statements. They should interpret the policies adopted and other technical financial matters.
- Implementing an internal control system that ensures errors and frauds are detected.
- Ensuring preventive measures are instituted to ensure errors and frauds do not occur
- Where errors and frauds have occurred, ensure that controls are in place to correct such
- Ensure controls are in place to detect errors and frauds in financial statements

c) Steps taken by the auditor where client has departed from accounting standard.
- Consider materiality of item. Consider the item in comparison with total of all class of items it relates to
- Consider the impact of departure in financial statements
- Check wither the departure has been properly disclosed and presented by ways of a note to financial statements
- Confirm whether the directors have the intention of correcting the departure by ensuring compliance in subsequent financial statements
- Consider reasons for departure from directors
- Consider whether the reasons for departure are justified

- Consider the possibility of the directors preparing revised financial statements with the correct financial statements i.e. statements that have complied with all the standards
- If the matter is material and the directors fail to do-operate to either revise the statements or disclose by way of note, the auditor should consider qualifying the audit report.

QUESTION EIGHT

a) The computerization of business operations has posed many challenges to the auditor. I. Difficulties experienced by the auditor in the use of test packs

Audit test data consists of data submitted by the auditor for processing by the client's computer based accounting system. It may be processed during a normal production run (running test data live) or during a special run at a point in time outside normal cycle (running test data dead). Approaches to test data are;

- ✓ Using live data
- ✓ Using dummy data in a normal production run
- ✓ Using dummy data in a special run Difficulties

i) Costs

There may be considerable costs involved in ascertaining the relevant controls and in constructing test data from scratch

ii) Objectives of the set

Test data is likely to be confined to tests of controls and may therefore be less valuable in audit terms than using audit software.

iii) Dangers of using live testing

Careful planning and control is needed to check test data from records

iv) Dangers of testing during a special run

If special test runs are used, an artificial testing environment is created. Assurance is needed that the normal program and files have been used.

v) Recording

Use of test packs does not necessarily provide visible evidence of the audit work performed. Working papers should therefore include details of the controls to be tested, an explanation of how they are tested, details of the transactions and files used, details of predicted results, actual results and evidence of the predicted and actual results having been compared.

II. Difficulties experienced by auditor in on-line system

Online computer systems are those that enable users to access data and programs directly through terminal devices. The risks in using real time systems is increased where terminal devices are dispersed and particularly where public as opposed to private telecommunication links are used. Unauthorised access may be deterred by use of protocols, encryption and call back procedures. Where on-line processing is interrupted, where telecommunication links are used, there is increased loss or corruption of data

The auditor must ensure that he understands the operation of such systems. He should test the operation of access controls such as passwords. He should test transaction logs where they exist for authorisation, completeness and accuracy.

The auditor may also reprocess transactions either as a test of control or as substantive procedure.

III. Difficulties experienced by auditor when auditing complex computerized system

Inherent risk
Due to a complex computerized environment, account balances are likely to be susceptible to material misstatement irrespective of related internal controls. This may lead to auditor expressing an inappropriate opinion on the financial statements.

Control risk
It is the risk that material misstatement could occur in an accrual balance which would not be detected or prevented by the accounting and internal control systems. This occurs in a complex computer environment which will increase audit risk

Detection risk
In a complex computerized environment, the auditor‘s substantive procedures may not detect material misstatement in account balances

Cost/Resources
A computerized environment will result to auditor applying Computer Audit Assisted Techniques which may be costly.

Need for technical skills
The auditor has to empty competent, skilled and experienced staff in information technology. This will be costly and will lead to an increase in audit fees.

Effect in audit planning
In planning the positions of the audit which may be affected by the client‘s environment.
The auditor should obtain an understanding of the significance and complexity of the computer information system activities and the availability of data for use in the audit

Security threats
A complex computer system is likely to have security threats due to unauthorised access to information through hacking. This will have an effect of the application programs and audit software used.

b) How the auditor verifies the following;

i) Standing data in a master file

- Check that all codes match those on master files e.g. employees number matches on employee number on the personnel file. The objective is to ensure that data is processed against the correct master file.
- Check on completeness to ensure that all transactions are recorded
- For validity check to ensure that only actual transactions have been properly authorized and recorded

iii) Alterations made in computer programs

- Check for authorisation to ensure that the staff who altered the program is different from the one who authorized.
- Check whether strict controls have been instituted to the changes
- Check whether a written request for an application program change has been made by use department
- Check whether the alterations have been authorized by a designated manager or committee
- Check whether documentation has been revised once the program has been redesigned.

- Check whether the changes in the program has been tested by the user and a systems employees who was not involved in designing the change
- Check whether approval of documented changes and results of testing should be given a systems manager
- Check if the proposed changes have been tested with incorrect or incomplete data as well as actual data to determine if controls have been properly implemented in the program

Part III: Comprehensive Mock Examinations

QUESTIONS - MOCKS

The following are three MOCK papers that address the major areas of the syllabus. It is recommended that candidates attempt the questions in an examination condition and then revise their answers using the suggested answers that follow.

Instructions:

Answer any FIVE questions. Note that marks allocated to each part of the question are shown at the end of the question.

Questions in this part are selected from across the topics in the entire syllabus. It will be important for the candidate to try and relate the questions to the appropriate topic or sub-topic of the syllabus.

Each question carries a total of 20 marks.

Time Allowed: 3 hours

QUESTIONS – MOCKS

MOCK ONE

QUESTION ONE

(a) What is an audit? (2 marks)
(b) Explain the importance of audit to a limited liability company. (10 marks)
(c) In addition to shareholders, many different parties are interested in the audited accounts of a company. Name FOUR such parties and state the significance of audited accounts to each one of them. (8 marks)

(Total: 20 marks)

QUESTION TWO

(a) Describe the following types of Audits:
  i. Statutory Audits;
  ii. Internal Audits;
  iii. Private Audits;
  iv. Management Audits;

(b) What are the similarities and differences between internal and external audits?

QUESTION THREE

a) Distinguish between internal audit and internal check (4 marks)
b) Explain the matters you would consider and the work you would perform to enable you assess the extent to which you would rely on the work of the internal audit department of your client (12 marks)
c) Give four examples of internal audit work that may e used by the external auditor (4 marks)

(Total: 20 marks)

QUESTION FOUR

You are the audit manager in charge of Car Alarms Ltd. Whose financial year ended on 31 March 1993. Due to the tight schedule of your programmes you are unable to devote anytime at the client‵s premises. Therefore you have delegated the responsibility to the audit senior.

(a) State the procedures you would follow to control the audit up to completion stage. (16 marks)

(b) Explain the matters you would pay attention to in order to achieve you firm‵s quality control targets. (4 marks)

(Total: 20 marks)

QUESTION FIVE

The auditing guideline on „recording‟ requires audit working papers to be sufficient complete and detailed so that an experienced auditor who has no previous connection with theaudit is able to subsequently ascertain from working papers the work performed and to further support the conclusions reached thereon.

Required:

(a) State four benefits that the auditor will obtain from the working papers that meet the above requirements. (4 marks)

(b) Outline the contents of a typical:

(i) Current audit file; (10 marks)

(ii) Permanent audit file. (6 marks)

(Total: 20 marks)

QUESTION SIX

John Mutiso bought shares of Sh.2 million six months ago in Kenya Company Limited which has since gone into liquidation. He intends to sue XYZ & Co. Certified Public Accountants for the imminent loss of Sh. 2 million which he is likely to suffer. XYZ & Co. had audited the Kenya Company Ltd. The previous year and issued an unqualified report. John Mutiso claims that he solely relied on the audit report when he took that investment decision.

Required:

a) Do the auditors, XYZ & Co. have any liability to Mr. John Mutiso? (4 marks)

b) What circumstances must Mr. John Mutiso demonstrate if he has to succeed against the auditors? (6 marks)

c) State the measures XYZ & Co. should undertake to minimize potential liability for professional negligence. (10 marks)

(Total: 20 marks)

QUESTION SEVEN

You have been asked by the partners of your firm to prepare a draft memorandum on materiality which will provide guidance to members of staff in conducting the audit of the accounts of limited companies.

Required:

a) Define materiality. (4 marks)

b) Explain the importance of this concept to the auditor. (6 marks)

c) Suggest some criteria for determining cut-off point in order to assess the materiality of an error. (10 marks)

(Total: 20 marks)

QUESTION EIGHT

(a) Explain why auditors carry out circularisation of debtors. (6 marks)

(b) Distinguish between ‗positive‘ and ‗negative‘ debtors circularisation procedures. (6 marks)

(c) Describe in detail the work you would carry out in scrutinizing the replies to the debtors circularisation and in confirming whether the debtors balances are collectable in the following situations:

i. where the debtor does not agree with the balance and states a difference; (6 marks)

ii. where the debtor reports that he cannot confirm the balance (2 marks)

iii. where no reply is received from the debtor (4 marks)

(Total: 20 marks)

MOCK TWO

QUESTION ONE

Emali Co. Ltd. has undergone a period of substantial growth following its establishment five years ago. At the last annual general meeting Smith & Co. Associates, a tow-partner firm ofCertified Public Accountants were re-appointed as auditors. However, Smith & Co. Associates have decided that they do not have the necessary resources to audit the enlarge company.

Required:

a) Briefly, explain how Smith & Co. Associates may resign from its appointment before the next annual general meting. (4 marks)

b) How any a casual vacancy arising from the resignation of present auditors be filled and what procedures are necessary before the company‘s next annual general meeting at which the appointment will be presented for ratification? (7 marks) c) Outline the steps the prospective auditor must take before deciding whether or not to accept the nomination as an auditor. (9 marks)

(Total: 20 marks)

QUESTION TWO

Restmount Kenya Ltd. was formed on 1 October 1997 in order to export tea and coffee to European markets. The Directors are unsure as to their responsibilities and the nature of their relationship with the external auditors. The audit partner has asked you to visit the client and explain to the directors, the fundamental aspects of the accountability of the directors and their relationship with the auditor.

Required:

Explain to the directors of Restmount Kenya Ltd: -

a) The need for an audit. (6 marks)

b) Procedures for the appointment of an auditor of a public company under the Companies Act. (5 marks)

c) Directors‘ responsibilities in relation to the accounting function of the Company. (4 marks)

d) Auditors‘ statutory responsibilities in relation to the audit of the company‘s financial statements. (5 marks)

(Total: 20 marks)

QUESTION THREE

(a) What is meant by the term ‗fraud‘? Give four examples of fraudulent activities. (6 marks)

(b) What do you consider to be the auditor‘s responsibilities in the course of the normal annual audit in relation to the detection of fraud? (6 marks)

(c) Explain the way in which the auditor should approach and perform his work in order to meet these responsibilities. (8 marks)

(Total: 20 marks)

QUESTION FOUR

During the final stage of the first audit of Nairobi National Bank Ltd. You request theclient to provide you with a letter of representation. The Client reads representations you are requesting and refuses to furnish the letter. The client states its position to be as follows:-

―You are asking us to tell you all manner of things which we appointed you to find out. You are requesting us to say such things as ‗all the transactions undertaken by the bank have been properly reflected in the accounting records' and yet we pay you to carry out the audit. You should know whether these statements are true or not‖.

Required:

a) Explain to the client the purpose of the letter of representation. (6 marks)

b) Describe the nature of the content of a letter of representation. Your answer should be illustrated with specific examples of items which may appear in a letter of representation. (6 marks)

d) Explain the reliability of a letter of representation as audit evidence and the extent to which the auditors could rely on this evidence. (5 marks)

d) Explain the consequences of your client's refusal to furnish a letter of representation. (3 marks)

(Total: 20 marks)

QUESTION FIVE

You are auditing the financial statements of Newbridge Trading plc, for the year-ended 31 October 1997.

The senior partner of your audit firm has asked you to consider the auditor's responsibilities for identifying subsequent events. Also, he has asked you to describe the audit procedures, which examine subsequent events. He has suggested that an example of one point in answer to part (b) below would be:

‗Checking sales ledger cash received after the year-end to determine the realisability ofdebtors at the year-end and highlight doubtful debts.'

The detailed audit work was completed on Friday 5 December 1997. It is proposed that:

a) The audit report will be signed on Friday 19 December;
b) The financial statements will be sent to shareholders on Monday 5 January 1998; and
c) The company's annual general meeting will be held on Wednesday 28 January 1998.

Required:

a) Consider the auditor's responsibilities for detecting material subsequent events in the periods:

i) 31 October to 5 December 1997
ii) 5 December to 19 December 1997
iii) 19 December 1997 to 5 January 1998
iv) 5 January 1998 to 28 January 1998
v) After 28 January 1998 (7 marks)

b) List and briefly explain audit procedures, which involve examination of subsequent events. (10 marks)

c) Describe the audit work you will carry out in period (a) (ii) above. (3 marks)

(Total: 20 marks)

Note: An alternative term for „subsequent events" is „post balance sheet events."

QUESTION SIX

(a) Define tests of controls, substantive procedures and walk-through tests. (6 marks)

(a) Explain how assessment of systems and controls impacts upon the main stages of the audit process (9 marks)

(c) Explain the role that internal control questionnaires and internal control evaluation questionnaires play in determining the effectiveness of the systems of internal control. (5 marks)

QUESTION SEVEN

In auditing the financial statements of companies which use computerized accounting systems, the auditors may find that this traditional (audit) trail is often obscured. Various techniques can be used in order to give the auditors greater assurance when the audit trail is lost.

Required

a) Explain why there is a possible loss of audit trail when companies utilize computerized accounting systems and why auditing through the computer assists the auditors in overcoming this loss of audit trail. (6 marks)

b) Explain how the auditors can use analytical procedures in order to give them greater assurance when there is a loss of audit trail. (4 marks)

c) Outline how audit software can be used by the auditors in order to assist them in carrying out their analytical procedures. (6 marks)

d) Explain the possible reasons and implications (audit) of significant changes in the following ratios when compared to the prior years ratios:
   i. The debtors turnover ratio has decreased over the year. (2 marks)
   ii. The stock turnover ratio has decreased from the previous year‘s rate. (2 marks)

(Total: 20 marks)

QUESTION EIGHT

Your firm is the auditor of Trent Textiles Ltd, and you are planning your audit work on the stock-take, which will be carried out at the firm‘s year-end of 31 May 19X3.

Trent Textiles manufactures knitted garments, including pullovers. The production process comprises:

(a) Knitting the individual components (e.g body and arms);
(b) Sewing the components together to form the finished garment;
(c) Cleaning, finishing, pressing and folding the garments;
(d) Packing the garments, ready for dispatch to the customer.

Trent Textiles does not have a perpetual inventory system, so the value of the stock in the accounts is found from the stock-take at the year-end. For management purposes, Trent Textiles carries out a full stock-take every three months.

Your permanent file of the company confirms that it has a single factory and no internal audit department.

You have been asked by the manager in charge of the audit to suggest the work you will perform at the stages listed below.

Required:

(a) State the work you will carry out prior to the commencement of the stock-take. (5 marks)
(b) State the procedures you will check during the stock-take to ensure the company‘s staff have accurately recorded the stock. (8 marks)
(c) State the work you will carry out and the matters you will record at the stock-take. (7 marks)

(Total: 20 marks)

MOCK THREE

Answer five questions

QUESTION ONE

Your firm is the newly appointed external auditor to a large company that sells, maintains and leases office equipment and furniture to its customers and you have been asked to co-operate with internal audit to keep total audit costs down. The company wants the external auditors to rely on some of the work already performed by internal audit.

The internal auditors provide the following services to the company:

(i) A cyclical audit of the operation of internal controls in the company‘s major functions (operations, finance, customer support and information services);
(ii) A review of the structure of internal controls in each major function every four years;
(iii) An annual review of the effectiveness of measures put in place by management to minimise the major risks facing the company.

During the current year, the company has gone through a major internal restructuring in its information services function and the internal auditors have been closely involved in the preparation of plans for restructuring, and in the related post-implementation review.

Required:
a) Explain the extent to which your firm will seek to rely on the work of the internal auditors in each of the areas noted above. (6 marks)
b) Describe the information your firm will seek from the internal auditors in order for you to determine the extent of your reliance. (6 marks)
c) Describe the circumstances in which it would not be possible to rely on the work of the internal auditors. (4 marks)
d) Explain why it will be necessary for your firm to perform its own work in certain audit areas in addition to relying on the work performed by internal audit. (4 marks)

(Total: 20 marks)

QUESTION TWO

(a) Internal controls over non-current assets are designed to ensure the orderly and efficient running of the business, adherence to management policies, safeguarding of assets, the prevention of fraud and error and the completeness and accuracy of the accounting records.

Required:
List the internal controls that a small printing company with office equipment, motor vehicles and plant and machinery should have in place to achieve the objectives described above. (10 marks)

(b) Audit sampling is a technique for drawing conclusions about the characteristics of a population by testing a sample drawn there from. Internal and external auditors use it for both tests of controls, and substantive testing.

Required:
Describe the following:
(i) Judgement sampling and statistical sampling;
(ii) A representative sample;
(iii) Tolerable error;
(iv) Two different methods of selecting a representative sample;

(v) The extrapolation of errors.
NB: Parts (i) – (v) carry equal marks. (10 marks)

(Total: 20 marks)

QUESTION THREE

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

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

Required:

(a) For each of the four examples given above, explain why the objectivity of the external auditor may be threatened, or appear to be threatened, and why the threat is important. (10 marks)

(b) Flowers Anytime sells flowers wholesale. Customers telephone the company and their orders are taken by clerks who take details of the flowers to be delivered, the address to which they are to be delivered, and account details of the customer. The clerks input these details into the company's computer system (whilst the order is being taken), which is integrated with the company's inventory control system. The company's standard credit terms are payment one month from the order (all orders are dispatched within 48 hours) and most customers pay by bank transfer. An accounts receivable ledger is maintained and statements are sent to customers once a month.

Credit limits are set by the credit controller according to a standard formula and are automatically applied by the computer system, as are the prices of flowers.

Required:

Describe and explain the purpose of the internal controls you might expect to see in the sales system at Flowers Anytime over the:

(i) Receipt, processing and recording of orders. (6 marks)
(ii) Collection of cash. (4 marks)

(Total: 20 marks)

QUESTION FOUR

Company A has a number of long and short-term payables, accruals and provisions in its balance sheet.
Required:

Describe the audit procedures you would apply to each of the three items listed below, including those relating to disclosure.

i) A 10-year bank loan with a variable interest rate and an overdraft both from the same bank. (5 marks)
ii) Expense accruals. (4 marks)
iii) Trade payables and purchase accruals. (6 marks)

(b) Company B has a provision in its balance sheet for claims made by customers for product defects under 1-year company warranties.

Required:
Describe the matters you would consider and the audit evidence you would require for the provision. (5 marks)

(Total: 20 marks)

QUESTION FIVE

Auditors obtain several different confirmations from various sources during the course of their audit.

Required:
Describe the audit evidence provided by each of the confirmations listed below, the practical difficulties in obtaining them and the alternative audit evidence available when they are not provided:

(a) Management representations. (7 marks)
(b) Direct confirmation of receivables. (7 marks)
(c) Confirmation of inventory held by third parties. (6 marks)

(Total: 20 marks)

QUESTION SIX

ISA 400 *Risk Assessments and Internal Control* deals with internal control objectives and internal controls. ISA 500
Audit Evidence deals with audit objectives and audit procedures. A proper understanding ofinternal controls is essential to auditors in order that they understand the business and are able to effectively plan and execute tests of controls and an appropriate level of substantive procedures.
You are the auditor of a small manufacturing company, that pays its staff in cash and by bank transfer and Maintains its payroll on a small stand-alone computer.

Required:
(a) For the payroll department, describe the:
  (i) Internal control *objectives* that should be in place; (4 marks)
  (ii) Internal control *environment* and internal control *procedures* that should be in place to achieve the internal control objectives. (6 marks)
(b) For the payroll charges and payroll balances (including cash) in the financial statements:
  (i) Describe the external auditor *audit objectives*; (4 marks)
  (ii) List the *tests of control* and *substantive procedures* that will be applied in order to achieve the audit objectives identified in (b) (i) above. (6 marks)

(Total: 20 marks)

QUESTION SEVEN

(a) Describe external auditor's responsibilities and the work that the auditor should perform in relation to the going concern status of companies. (5 marks)
(b) Describe the possible audit reports that can be issued where the going concern status of a company is called into question; your answer should describe the circumstances in which they can be issued. (5 marks)

Celtel is a large telecommunications company that is listed on the Nairobi Stock Exchange. It is highly geared because, like many such companies, it borrowed a large sum to pay for a license to operate a mobile phone network with technology that has not proved popular.
The company's share price has dropped by 50% during the last three years and there have been several changes of senior management during that period. There has been considerable speculation in the press over the last six months about whether the company can survive

without being taken over by a rival. There have been three approaches made to the company by other companies regarding a possible takeover but all have failed, mainly because the bidders pulled out of the deal as a result of the drop in share prices generally.

The company has net assets, but has found it necessary to severely curtail its capital investment program. Some commentators consider this to be fundamental to the future growth of the business, others consider that the existing business is fundamentally sound. It has also been necessary for the company to restructure its finances. Detailed disclosures of all of these matters have always been made in the financial statements. No reference has been made to the going concern status of the company in previous auditor‘s reports on financial statements and the deterioration in circumstances in the current year is no worse than it has been in previous years.

Required:

a) On the basis of the information provided above, describe the audit report that you consider is likely to be issued in the case of Celtel, giving reasons. (4 marks)

b) Explain the difficulties that would be faced by Celtel and its auditors if Celtel‘s audit report made reference to going concern issues. (6 marks)

(Total: 20 marks)

QUESTION EIGHT

You are an audit manager in an audit firm with 250 staff. Your firm is the auditor of Sunrise, a chain of Supermarkets. Your firm has been the auditor of this client for many years.

All of the planning work and tests of control have been completed for Sunrise for the year ended 31 December 2003. Staff are still working on substantive procedures. The company operates a continuous inventory checking system with good records and you have tested this system and will be relying on the records for the year-end balance.

The company is intending to invest a substantial amount in opening new stores during the next year and it has been negotiating with both banks and property companies in relation to leases.

Required:

(a) Describe the objectives of the following and how these objectives will be met in the audit of Sunrise:

(i) Overall review of financial statements; (4 marks)

(ii) Review of working papers. (6 marks)

(b) Describe the:

(i) Auditor‘s responsibilities with regard to subsequent events; (6 marks)

(ii) Procedures that should be applied during the subsequent events review at Sunrise. (4 marks)

(Total: 20 marks)

MOCK FOUR

Answer five questions

QUESTION ONE

a) Internal control systems are designed, amongst other things, to prevent error and misappropriation.

Required:

Describe the errors and misappropriations that may occur if the following are not properly controlled:

(i) Receipts paid into bank accounts; (2 marks)
(ii) Payments made out of bank accounts; (3 marks)
(iii) Interest and charges debited and credited to bank accounts. (2 marks)

(b) A book-selling company has a head office and 25 shops, each of which holds cash (banknotes, coins, and credit card vouchers) at the balance sheet date. There are no receivables. Accounting records are held at shops. Shops make returns to head office and head office holds its own accounting records. Your firm has been the external auditor to the company for many years and has offices near to the location of some but not all of the shops.

Required:

List the audit objectives for the audit of cash and state how you would gain the audit evidence in relation to those objectives at the year-end. (8 marks)

c) The external auditors of companies often write to companies' bankers asking for details of bank balances and other matters at the year-end.

Required:
Explain why auditors write to companies' bankers and list the matters you would expect banks to confirm. (5 marks)

(Total: 20 marks)

QUESTION TWO

Towards the end of an audit, it is common for the external auditor to seek a letter of representation (written representations) from the management of the client company.

Required:
(a) Explain why auditors seek letters of representation. (5 marks)
(b) List the matters commonly included in the letter of representation. (6 marks)
(c) Explain why it is important to discuss the content of the letter of representation at an early stage during the audit. (3 marks)
(d) Explain why management is sometimes unwilling to sign a letter of representation and describe the actions an external auditor can take if management refuses to sign a letter of representation. (6 marks)

(Total: 20 marks)

QUESTION THREE

The responsibilities of external auditors are not always well understood, especially with regard to the detection and reporting of fraud. When external auditors provide non-audit services to their audit clients, it is essential that the auditors make a clear distinction between their audit and non-audit responsibilities.

Required:

a) Explain the responsibilities of external auditors to directors and shareholders. (5 marks)

b) Describe the limitations of the external audit in relation to the detection and reporting of fraud. (5 marks)

c) Explain why it is essential for external auditors to be independent of their clients. (5 marks)

d) Explain the advantages and disadvantages of external auditors providing consulting services to their audit clients. (5 marks)

(Total: 20 marks)

QUESTION FOUR

You are carrying out the audit of ACB Computers limited for the year ended 31 December 2003. The company assembles microcomputers purchased from the Far East and sells them to retailers, and to individuals and other businesses. In the current year, there has been a recession and strong competition, which has resulted in a fall in sales and the profits. This has led to a trading loss and the company is experiencing going concern problems.

Required

a) Describe the factors, which indicate that a company may not be a going concern. Your list should include all factors and not just those, which relate to ACB Computers Limited. (10 Marks)

b) Consider the form of audit report (i.e. qualified or unqualified) you would issue of ACB Computers limited if you conclude that the company is experiencing serious going concern problems, in the following two situations:

   I) You conclude that the financial statements give sufficient disclosure of the going concern problems.

   II) There is no disclosure of the going concern problems in the financial statements and you believe there is a serious risk that the company will fail in the foreseeable future (6 marks)

c) State the parties who may successfully sue you as auditor for negligence, and consider the arguments you could include in your defense when:

   I) The financial statements of ACB Computers Limited for the year ended 31 December 2003 do not mention any going concern problems and your audit report on these financial statements was unqualified and

   II) The company fails on 15 February 2004 (4 marks)

QUESTION FIVE

Your firm is the auditor of Shah Engineering Ltd, and you have been asked to suggest the audit work you will carry out in verifying trade creditors and purchase accruals at the company‘s year-end of 31 December 2003. You attended the stock take at the year-end.

The Company operates from a single site and all raw materials for production are received by the goods inwards department. When the materials are received they are checked for quantity and quality to the delivery note and purchase order, and a multi—part goods received note is made out and signed by the storekeeper. If there are any problems with the raw materials, a discrepancy note is raised which gives details of the problems (e.g., incorrect quantities or faulty materials)

The purchase accounting department receive the purchase invoice, check them to the purchase order and goods received note and post them to the purchase ledger. At the end of each month, payments are made to suppliers. The purchase ledger is maintained on a microcomputer.

The main sundry creditors and accruals at the year-end include:

a) Wages accruals and PAYE;
b) VAT;
c) Interest on loans overdrafts, telephone and electricity.
Most employees' wages are paid weekly in arrears.

You are required to describe in detail the audit work you will carry out to:

a) Check suppliers' statements to the balances on the purchases ledger; (8 marks)
b) Verify that purchases cut-off has been correctly carried out at the year end (5 marks)
c) Ensure that sundry creditors and accruals are correctly stated; (7 marks)

QUESTION SIX

(a) Briefly explain the meaning of the term "control procedures". (4 marks)
(b) What is the importance of segregation of duties as a control procedure'? (4 marks)
(h) In carrying out an audit, the auditor appraises and tests the system of internal control in order to ascertain that it is capable of processing transactions or determining quantities and values completely and accurately. The auditor further carries out substantive tests in an attempt to ensure that the transactions, assets and liabilities recorded in the accounting records upon which the figures in the financial statements are based, are completely and accurately recorded.

Required:

List and briefly explain the substantive tests the auditor would carry out to verify the values attributed to:
(i) Trade debtors in a company's financial statements. (6 marks)
(ii) Trade creditors in a company's financial statements. (6 marks)

(Total: 20 marks)

QUESTION SEVEN

a) In the context of a computer based accounting system, explain the meaning of the following terms:
 i. Application controls; (4 marks)
 ii. General controls (4 marks)
b) Explain the importance of having proper systems documentation (6 marks)

c) A Company wishes to change from an old computerised system to a new computer based accounting system. Explain how and why both systems should run parallel prior to the change over to the new system. (6 marks)

(Total: 20 marks)

QUESTION EIGHT

You are the manager responsible for the audit of ABC Company, which has a turnover of KShs 750 million. The company has been audited by your firm for a number of years and this is the second year you have been responsible as manager for the audit. However, owing to your responsibilities for other audits you are only intending to make periodic visits to the company during the course of the audit and you will not be involved in any of the detailed audit work.

Required

a) State the matters you would consider in planning the audit, prior to the commencement of the detailed audit work. (13 marks)

b) Describe the way in which you would control the audit from the commencement of the work by the audit staff to the review stage by the partner immediately prior to him signing the audit report (7 marks)

(Total: 20 marks)

ANSWERS - MOCKS
SUGGESTED ANSWERS TO MOCK EXAMS

MOCK ONE

QUESTION ONE

(a) The explanatory foreword to the International Standards on Auditing (ISA) describes audit as the independent examination of and expression of an opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.

The objective of an audit is to enable auditors to express an opinion whether the financial status give a true and fair view and have been properly prepared in accordance with the relevant statutory requirements.

NB: - The auditor does not <u>certify</u> the financial status but reports that in his <u>opinion</u> they give a true and fair view.

b) Importance of audit to a limited company

- An audit protects the interests of the shareholders who are separated from the management of the company. This is especially the case for minority shareholders who have little say in the management of their company.
- An audit being an independent examination of the financial statements gives credibility to the financial statements. The various users can therefore place reliance on them;
- The audit ensures that the directors have fulfilled their statutory obligations and acts as a precaution against frauds on the part of employees.
- The auditors experience will enable him to make recommendations on ways of improving the accounting, internal control system and in the standards of the company's reporting to its members.
- An audit ensures that the financial statements are prepared in accordance with the generally accepted accounting standards. This improves the comparability of the financial statements.

c) **Users of financial statements**

i) Tax authorities: Audited accounts give a true picture of the entity's profits and can be relied upon by tax authorities for the assessment of tax on the company.

ii) Lenders:- audited accounts are credible and therefore can be relied upon to assess the credit worthiness of the entity.

iii) Employees – Are interested in whether the entity is a going concern, which can be established from the audited accounts to ensure job security.

iv) Customers – those who rely on entity's products are interested on whether the entity will be producing in future (going concern) or whether they ought to look for alternative suppliers

v) Potential/actual investors need to know whether investing in the company is worthwhile i.e are they bound to benefit financially in terms of dividends and capital gains.

QUESTION TWO

a (i) Statutory audits

These are carried out as per the requirements of the various statutes e.g. the Companies Act cap 486 requires that all public limited companies must have their financial statements subjected to an independent audit. The objectives of the audit are to express an opinion as to whether the balance sheet and the profit and loss account show a true and fair view. The rights and duties of the auditor are laid out in the Companies Act or the relevant statute. The powers of appointment of the auditor are vested on the shareholders.

(ii) Internal audits

Internal audits is an appraisal or monitoring activity established by management for the review of accounting and Internal Control System as a service to the entity. It examines, evaluates and reports to management on the adequacy and effectiveness of the systems.
Other activities include: -

a) Examination and evaluation of financial and operating information.
b) Review of the economy, efficiency and effectiveness of operations including non-financial controls
c) Review of compliance with external laws and regulations and internal policies and procedures.
d) Carrying out special investigations including fraud investigations as required by management.

It is important to note that internal audit is a management function established to carry out a continuous appraisal on the internal controls system and report this to management.

(iii) Private audits

These are audits that are not governed by the Companies Act or any other statute. These are performed by an independent auditor because the owners, members or other interested parties require them and not because the law requires them to be carried out. Private audits are carried out for organisations such as NGOs, partnerships, clubs and charities among others. The appointment of the auditor is usually carried out as a private contract between the auditor and the relevant stakeholder. The scope and objective of the work is determined by the agreed terms between the auditor and the client. The auditors' rights and duties are also laid out in the contract.

(iv) Management audits

Management audits relate to the review and evaluation of the management structure within the organization and the performance of the management. It includes the appraisal of the environment for the exercise of management skills as well as the measurement of external management performance against established criteria.

(b) Similarities between internal and external audits

- Both functions require the auditors to adhere to the international standards on auditing.
- Both are carried out by competent auditors
- Both are interested in evaluating and testing the effective operations of the internal control system
- Both functions give recommendations to management on ways of improving the internal control system. The external auditor achieves this through the management letter, which is addressed to management.

Differences

Area of difference	Internal Auditor	External auditor
1. Scope	Determined by management	Determined by statute
2. Approach	To ensure accounting system is efficient and providing management with accurate information	To satisfy himself that the financial statements to be presented to the shareholders portray a true and fair view
3. Responsibility	Report to management	Report to the shareholders of the company

QUESTION THREE

Internal Audit is an appraisal or monitoring

a) Internal check is an element of the internal controls system where the activities of an individual in the organization/entity is automatically checked by another. This is facilitated by segregation of duties where by the various activities in transaction processing are carried out by independent persons. For example in the purchase of raw materials the person paying the supplier's invoices counterchecks to ensure that the amount billed by the supplier agrees with the cost of the purchase as per the authorised purchase order. This independent check is an example of internal check. On the other hand internal audit Internal audits is an appraisal or monitoring activity established by management for the review of accounting and Internal Control System as a service to the entity. It examines, evaluates and reports to management on the adequacy and effectiveness of the systems.

b) Before deciding whether to rely on the work of the internal audit function with the intention of reducing audit procedures the external auditor should evaluate the internal audit function to determine the scope of the function, its independence and hence how much reliance can be placed on the work that it carries out.

In evaluating this function the external auditor should consider the following factors:

- **Organization status**
  Since internal audit function is part of the entity it cannot be totally independent. To boost it's independence the status of the function within the organization should be such that the internal auditor reports to the highest level of management. The internal

auditor should also be free of any other operating responsibility such as performing accounting functions, which may conflict with his role as an independent watchdog of controls and operations of the entity. There should be no restrictions placed upon his work by management. Such restrictions could impair the effectiveness of the function.

- **Scope of the function**

  The external auditor should ascertain the nature and depth of coverage of internal audit assignments. He should also ascertain whether management considers and acts upon internal audit recommendations. Where the recommendations are not acted upon this represents a weakness in the function and hence the level of reliance should consequently be reduced.
- **Technical competence**

  The external auditor should ascertain whether internal audit work is performed by persons having adequate technical as auditors. Qualifications and experience of the internal audit staff should be considered.
- **Due professional care**

  The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. Exercise of due professional care is evidenced by the existence of adequate audit manuals, work programs and working papers.
  - **Internal audit reports**

    The external auditor should consider the quality of the internal audit reports prepared and submitted for management action. He should ascertain whether management considers, responds to and acts upon internal audit reports and whether there is evidence to prove that action.
  - **Level of resources available**

    The external auditor should consider whether internal audit has adequate resources to be able to carry out their duties effectively. Such resources would include staff and computer facilities.

    After carrying out this assessment the external auditor will then decide whether the function is effective and the auditor can therefore rely on some of the work carried out by internal audit.

If the external auditor wishes to rely on some specific work carried out by internal audit the following factors should be considered:

a. The work is performed by staff who have adequate technical training and proficiency as internal auditors;
b. the work of assistants is properly supervised, reviewed and documented;
c. sufficient appropriate audit evidence is obtained to form a reasonable basis for the conclusions reached;
d. the conclusions reached are appropriate;
e. reports by the internal audit are consistent with the results of the work performed;
f. any exceptions and unusual matters disclosed by internal audit are properly resolved;
g. amendments to the external audit programme are required as a result of matters identified by the internal audit work;
h. there is a need to test the work of internal audit to confirm its adequacy.

c) Examples of internal audit work that can be used by the external auditor includes:

1. The physical verification of assets. The internal auditor could undertake a physical verification of assets to confirm their existence; the results of such work could be relied upon by the external auditor.
2. To undertake on behalf of the external auditor to observe the stock take exercise, cash counts, and
   attendance at wage payments.

3. Point out areas where there have been fundamental changes in accounting, management and internal control system all of which could have an impact on the audit approach;
4. The internal auditor could also perform some substantive procedures on behalf of the external auditor such as evaluating the recoverability of debtors balances

QUESTION FOUR

(i) As the audit manager has decided to delegate his responsibilities to the audit senior, he must ensure that his senior has the appropriate experience, training, proficiency and independence required in order to be able to carry out the audit of Car Alarms Ltd efficiently and effectively.

Having decided to delegate he must ensure that the audit senior receives the direction and supervision necessary to be able to conduct the audit in the best way possible. The degree of supervision requested will depend on the complexity of the assignment and the experience and proficiency of the audit senior,

In the course of directing the audit senior, he should inform him of his responsibilities and the objectives of the procedures that he is to perform. He should also inform him of the routine of the business carried out by Car Alarms ltd and the possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved.

When supervising the auditor he should:-

i) Monitor the progress of the work to determine that: -
   i. the audit senior appears to have the necessary skill and competence carry out the audit of Car Alarms Ltd
   ii. he appears to have understand the audit directions and the work is being carried out in accordance with the audit programme and other planning documents.
   (iii) Become informed of significant auditing questions raised during the audit, assess their significant and modify the audit programme where appropriate.

In addition to the above, he should review the work performed by the audit senior to determine whether:-

- The work performed and results obtained have been adequately documented.
- No significant audit matters remain unresolved.
- The objectives of the audit procedures have been achieved and the conclusions expressed are consistent with the results of the work performed and support the audit seniors opinion on the final stages

b) In order to achieve the firm's quality control targets the following matters should be considered:
   i) Personnel qualities: Personnel in the firm should adhere to the principles of integrity, objectivity, independence and confidentiality.
   ii) Skills and competence: The firm should be staffed by personnel who have attained and maintain the skills and competence required to enable them to fulfil their responsibilities.
   iii) Assignment: Audit work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
   iv) Director and supervision at all levels to provide the firm with reasonable assurance that the work performed by the firm meets appropriate standards of quality.

vi) Acceptance and continuance of clients: In making such decisions, the firms should consider its own ability to service a client properly and the integrity of the client's management.

vi) Monitoring: The firm should monitor the effectiveness of its quality control policies and procedures.

QUESTION FIVE

a) Benefits of working papers

- The reporting partner needs to satisfy himself that work delegated by him has been properly performed. This is only possible by reviewing detailed working papers prepared by the audit staff who performed the work. This also aids in supervision and review of work done by audit assistants.
- Working papers provide details of problems encountered together with evidence of work performed and conclusions drawn there from in arriving at the conclusions reached. These details can also serve as a good reference point for future audits.
- Preparation of working papers encourages the auditor to adopt a methodical approach to his work.
- Working papers assist in the planning and performance of audits in future financial periods.
- If sued for negligence working papers act as evidence of work done.
- They are used for training of audit staff. Working papers contain audit programs and specimen schedules, which audit assistants, can refer to when conducting an audit.

Current Audit File (CAF):

This file will contain matters only relevant to the current year's audit only. It will contain:

- A copy of the accounts being audited signed by the directors;
- A file index showing the contents of the file;
- A description of the internal control system inform of questionnaires, flowcharts or forms of documentation;
- Audit programmes showing the audit objectives and planned audit procedures for each of the areas to be audited;
- A schedule of each item in the balance sheet. Each schedule should show:
  - Balance at the beginning of the year, changes during the year and balance at the end of the year.
  - Details of work performed on each balance, results and the conclusions made
- A schedule for each item in the profit and loss account showing the audit work carried out, results obtained and the conclusion reached;
- Check list for compliance with statutory disclosure requirements and accounting standards;
- Record of queries raised during the audit and coming forward from previous audit.
- Schedule of important statistics e.g. output, net profit margin, gross profit margin, sales composition, liquidity ratios;
- A record or abstract from the minutes of:
  - The company
  - The directors
  - Any internal committee of the company whose deliberations are important to the auditor.
- The management letter setting out weaknesses in the internal control;

Letters of representation obtained from the client's management.

Permanent Audit File (PAF):

The permanent file usually contains documents and matters of continuing importance, which are required for more than one financial period. Information contained in a PAF include:

- Statutory material: governing the conduct of the audit e.g. for companies, the Companies Act (Cap 486). For a quoted company a copy of the Nairobi Stock Exchange regulations (NSE) is required.
- Rules and regulations of the enterprise. E.g. for a company, the Memorandum and Articles of Association. For a partnership, a partnership agreement.
- Copies of documents of continuing importance and relevance to the auditor. -Letter of engagement and minutes of appointment of the auditor.
  - Trade license.
  - Debenture deeds.
  - Lease agreements
  - Guarantees and indemnities entered into.
- Addresses of the registered office and all other premises with a short description of the work carried on at each.
- An organisation chart showing: -
  - Principal departments and subdivision thereof.
  - Names of responsible officials showing lines of responsibility.
- A list of directors their shareholdings and service contracts;
- A list of company's advisors, bankers, stockbrokers, solicitors, valuers.

QUESTION SIX

a) NO: A shareholder cannot sue the auditor individually if he relied solely on audited financial statements as a basis for investing in a company.

However the auditor could be liable if he knew that his report would be used to make investment decision _Hedley Byrne principle'

—Third parties entitled to recover damages under this principle are be limited to thosewho by reason of the accountants negligence in preparing reports, accounts or financial statements suffered financial loss and where the accountant knew or ought to have known that the report, accounts or financial statements in question were being reported for specific purpose or transactions which gave rise to the loss or that they will be shown to, and relied upon by third parties in that particular connection.

This position was supported by the decision In *Re: Candler Vs Crank Christmas & Co(UK case)*

Candler was induced to invest money in a company on the strength of audited financial statements and subsequently he lost his investment when the company wound up.

Lord Denning stated that, — accountants owe theirduty of course, to their employer orclients and also, I think to any 3rd person to whom they themselves show the accounts or to whom the know their employer is going to show the accounts so as to induce him to invest money or take some action on them. I do not think, however, the duty can be extended still further so as to include strangers of whom they have heard nothing and to whom their employer without their knowledge may choose to show the accounts‖

This judgment appears to imply that various users of audited financial statements such as creditors, potential investors e.t.c may not be able to sue the auditor for negligence by virtue of their placing reliance on audited financial statements.

Basing on this judicial precedence it appears that John Mutiso cannot successfully sue XYZ certified accountants.

b) Mr. Mutiso must prove that: -

i That XYZ company indeed carried out the audit work negligently

ii That as a direct consequence of XYZ's negligence he suffered financial loss

iii That XYZ knew or ought to have known that the accounts will be relied upon for investment decisions by John Mutiso i.e prove that XYZ Co. owed him a duty of care.

iv That Mr. Mutiso actually relied on the report. No other external auditors whatsoever influenced his decision making but just that of the audit report.

c) The auditor should ensure that he is competent enough to carry out the audit assignment in order to be able to carry it out according to the professional standards. He should also ensure that he actually conducts this audit in accordance to the standards set by both professional and ethical bodies and in utmost care. By doing so, he will be able to prove that the audit was not carried out negligently.

The audit should be carried out in detail and every aspect of it taken seriously. If the information necessary in one area are unavailable. The auditor should obtain a letter of representation in order to ensure that he makes an informed decision and he can be able to prove so, if the need arises.

The auditor can enter into an agreement with his client that his report should not be used by another person apart from the client.

Include a disclaimer of liability clause in the relevant document or report. Example of such a clause would be ― while every care has been taken in the preparation of this document, it may contain errors for which we cannot be held responsible‖

Taking professional indemnity insurance cover.

QUESTION SEVEN

a) The auditor should consider materiality when conducting his audit. Materiality is defined as follows. ―Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements‖. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

Thus materiality provides a threshold or cut off point rather than being a primary qualitative characteristic which information must have if it is to be useful. The concept of materiality is key to the auditor when he is concluding whether financial statements show a true and fair view. The auditor can only report that the financial statements do not show a true and fair view on issues that are material. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

The auditor should consider materiality at both the overall financial statements level and in relation to individual account balances, classes of transactions and disclosures

b) Materiality is important to an auditor because: -

- Auditors should consider materiality and its relationship with audit risk when conducting an audit. The auditors responsibility is to plan and perform an audit to provide reasonable assurance that the financial statements are free of material misstatement and give a true and fair view. Thus anything that would distort the view given by the financial statements must lead to a qualification but only if its material.

- Auditors should consider materiality when determining the nature, timing and extent of audit procedures.

  Materiality assessments during planning assists in the determination of an efficient and effective audit approach. It helps the auditor decide on matters such as what items to examine and whether to use sampling techniques.

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

- If the auditor believes that the aggregate of uncorrected misstatements may be material, he should extend his audit procedures to obtain more audit evidence in the relevant area or request management to adjust the financial statements.

  If management refuses any adjustments the auditor should consider the implications for his audit report.

- Therefore materiality provides a reference point in making decisions on the effects of misstatements on the financial statements.

c) Materiality guidelines can be derived by answering the following questions:-

- Who are the relevant users of the financial information?
- What are their decision making needs?
- For a given item, what is the appropriate context for assessing its materiality?
- In what range of values do items become critical in terms of materiality?
- How should particular items in these critical ranges be decided and reported?

The auditor should also consider:-

- Is the item so fundamental that the accounts can no longer be said to give a true and fair view?
- Materiality is a relative factor and the item must be considered in relation to the accounts as a whole, the total of which it would form part and the corresponding amount in the previous years.
- Some items are capable of exact calculations others like depreciation are merely estimated and providing the estimate is reasonable, should be acceptable.

However, it is generally accepted that:-

a) Errors over 10% are material
b) Errors between 5 – 10% may be material
c) Errors under 5% may not be material.

QUESTION EIGHT

a) The most effective way of confirming debtor balances is by the auditor communicating directly with the customers of the client to seek direct confirmation of the amounts outstanding.

Circularization satisfies the following objectives: -

- Strong evidence whether debtors are overstated – Customers can usually be relied upon to complain if the balance they are supposed to owe is overstated (i.e. completeness and accuracy). However, it is a weaker source of evidence on whether debtors are understated – customers are less likely to kiliicomplain if the balance is too small.
- Evidence of the functioning of controls i.e. if the ICS over debtors is strong, there will be few discrepancies regarding what is stated by the debtors and what is stated in the clients records
- Evidence of the efficiency of cut-off procedures if carried out at year-end.
- Evidence regarding irregularities such as ―teeming and lading‖ and window dressing.
- Provides reliable evidence on existence of debtors.

b) In positive circularization the debtor is asked to confirm to the auditor directly if he agrees or disagrees with the balance whereas in negative circularization, the customer is only asked to respond if he disagrees with the balance stated in the request letter. Positive circularisation is mainly used where the debtors' balances are material and the internal controls are not very reliable while negative circularisation is mainly used where the debtors' balances are not very significant.

c) Debtors' circularisation

i) Where the debtor does not agree with the balance and states a different balance

The fact that the debtor has replied and stated a different balance confirms the existence of the debtor. However, the auditor will need to carry out the following procedures to confirm completeness, accuracy and collectability of the debt:

- Evaluate the causes of the difference between the balance in the client's ledger and the amount the debtor has confirmed. This could be as a result of either invoices or payments in transit. Invoices in transit refers to instances where the client has sent invoices for sales to the customer but these have not been recorded in the customer's books. Payments in transit refers to instances where the debtor has made some payments but these have not yet reached the client or maybe the client has received the payment but has not posted this in the ledger. Where payments has received the payment the client will need to post these in the ledger;
- Other variances should be investigated and management should provide appropriate explanations. Where necessary adjustments should be made record any unrecorded transactions;
- Check any payments received after year end as evidence of collectability of the debtors balance;
- Analyse the account to confirm that the balance is within the credit terms and discuss with management the recoverability of the balance.

ii) Where the debtor reports that he cannot confirm the balance

- The fact the debtor has replied confirms existence;
- To confirm the completeness of the amount the auditor should analyse the debtors account to ensure that the balance is made of specific invoices supporting sales to the debtor;
- The auditor should discuss with management the collectability of the balance.

iii) Where no reply has been received

Where no reply has been received implies that the auditor has not been able to confirm the existence of the debtor. The auditor will need to carry out alternative audit procedures, which include:

- Inspecting correspondence between the client and the debtor. This will assist in confirming existence of the debtor;
- Analysing the debtor's account to verify that the balance is made up of specific invoices. The auditor can inspect a sample of these invoices;
  - Verifying if there are any payments that have been received after the year-end. This will confirm existence and collectability of the balance. Where the entire amount has been settled in one single payment this could also assist in confirming the completeness of the balance;
  - The auditor should discuss the account with management if there are any indications that the balance is doubtful.

MOCK TWO

QUESTION ONE

a) If Smith & Co. wish to resign from its appointment before the next AGM, they must carry out the following procedures:

1. Smith & Co. must deposit written notice of their resignation at the registered office of Emali Co. The resignation is effective on the day it is received unless the auditors have specified some later date

2. Smith & Co. must accompany such notice with a statement that either: -

   a) There were no circumstances connected with this resignation which they consider should be brought to the notice of the members or creditors of the company or
   b) A statement detailing any such surrounding circumstances which in the case of Smith & Co. for example in this case Smith & Co could state that their resignation was as a result of the fact that they believe that their firm does not have the capacity to serve the company as a result of its rapid growth.

Additional considerations (do not form part of the answer)

Resignation under different circumstances

Where the auditors are resigning due to a disagreement with management in addition to depositing the explanatory Statement at the company's registered office, the auditors may attach a signed requisition for the directors to convene an extra ordinary General Meeting in order for circumstances surrounding his resignation can be brought to the attention of shareholders. A 28 days notice for the meeting is required.

Before the meeting is convened, the auditors may request the coy to circulate to its members a written statement of circumstances. If for any reason this fails to happen, the statement can be read out at the meeting.

b) Section 159 (6) Casual vacancies

The companies Act provides that the directors may fill any casual vacancy in the office of the auditor, but while any such vacancy continues the surviving or continuining auditor or auditors, if any, may act. A casual vacancy could arise as a result of:
i) death
ii) incapacitation or
iii) resignation

Basing on this provision the directors can fill the vacancy created by the resignation of Smith & Co. however; the shareholders of the company still have a right to remove the auditor so appointed during the AGM.

c) Before accepting nomination as the company"s auditor the following Stepsand factors should be considered Statutory matters

Ensure that your firm is professionally, legally and ethically qualified to act as an auditor. The auditor must ensure that he has not contravened any provisions of the companies Act in regard to independence. He must ensure that he is not a servant or in partnership with a servant of the company. In case Relief Supplies has a holding company or subsidiaries it is also important to ensure that your firm has not previously been disqualified from being eligible for appointment as auditors of such subsidiaries or the holding company.

Ethical matters

- Your firm must also ensure that it has fulfilled all the professional ethical requirements in regard to independence. I.e. the firm must not have any personal, family or business relationships with the prospective client among other provisions;

- Your firm should establish it has the technical proficiency to undertake the audit. This will include determining whether the firm posses the necessary technical skills to carry out the assignment;

- Establish whether the firm‗s resources are adequate to service the needs of the new client i.e. staff time with the necessary technical competence and experience;

- Your firm should seek references about the status of the company and its management. Such references will assist the auditor in assessing the potential risk in associating with this new client. Information sought would include the reputation of the company and its directors. It is a professional requirement that very firm must evaluate all prospective clients before accepting appointment. Seeking references about the client provides useful information in carrying out this evaluation;

- I would try to determine the reason for the change in auditor. The question says that the directors believe they do not receive a cost effective service from the existing auditor. However, there may be problems with the level of audit fee or the existing auditor may want to qualify his report which the directors are trying to prevent;

- I would obtain a copy of the previous years audited accounts. If the audit report is qualified, it indicates that the audit has a higher than normal risk. From these accounts I would assess whether the company is having going concern problems by calculating appropriate ratios such as the gearing ratio and if there could be weaknesses in the system of internal control;

- I would check that no conflict of interest arises through my acceptance of appointment as auditor of the company;

- I would consider the level of fee I would charge. It should be sufficient to provide an acceptable return, as an inadequate fee could result in insufficient audit work being carried out and thus increase the audit risk;

- Communicate to the outgoing auditor-Your firm should request Relief Supplies permission to communicate with the existing/outgoing auditor. If such permission is denied your firm should decline the appointment. If your firm receives permission from the client, you should write to the existing auditor requesting all the information which ought to be made available to you to enable you decide whether or not you are prepared to accept appointment. Communication with the existing auditor is not just a matter of professional courtesy. Its main purpose is to enable the prospective auditor ensure that there are no reasons which preclude him from accepting the appointment. It would be important at this stage to confirm with the outgoing auditor whether the true reason for being requested to resign is because their firm is perceived by management as not providing a value for money audit or could there be other reasons behind this.

Before replying to the prospective auditor the outgoing auditor should obtain the client‘s permission to discuss his affairs fully with the prospective auditor. If the outgoing auditor is duly authorized by the client to discuss the client‘s affairs with the prospective auditor, then he may communicate any relevant information he believes to be true, including the reasons for the proposed change and any other matter he considers that the prospective auditor should be made aware.

The prospective auditor must treat any information given by the outgoing auditor in the strictest confidence and should weigh this carefully in reaching a decision whether or not to accept the appointment.

If the client refuses the existing auditor authority to discuss his affairs with the prospective auditor, the outgoing auditor should inform the prospective auditor who should then decline the appointment.

If the outgoing auditor considers that there are professional reasons to prevent the prospective auditor accepting nomination he must disclose these to the prospective auditor. The prospective auditor should endeavor to ascertain the reasons for the change in auditors. If after doing this, he is of the opinion that the existing auditor is being treated unfairly, he may decline the appointment.
Therefore communicating with the outgoing auditor is important:

- To get necessary information that could guide him on whether to accept or reject nomination;
- To enquire on the reasons for the change in auditors;
- Professional courtesy.

Having considered these factors your firm should then make a decision on whether to accept the appointment.

After your firm accepts nomination it should carry out the following procedures

- Ensure that the removal or resignation of existing auditor is properly carried out in accordance with the Companies Act Chapter 486. I.e. a simple resolution was passed at the AGM removing the current auditors.
- That your appointment is valid and obtain a copy of new resolution passed in AGM to appoint you as the new auditor.
- Set up a letter of engagement to the directors of company.

QUESTION TWO

a) Need for an audit

Today most businesses are operated by limited companies, which are owned by the shareholders and managed by directors appointed by such shareholders. The appointed management is faced with a conflict of interest i.e. whether to act in the best interest of the company and by extension the shareholders‘ interest or to act in their best interest. This is what is referred to as the agency problem.

The separation that exists between the owners and management forces the absentee owners to institute control measures to ensure honesty of their company‘s stewards (i.e. management). The companies Act attempts to remedy this problem by requiring the management to maintain proper accounting records of all the transactions of the company and to prepare financial statements that show a true and fair view to be presented to the shareholders at the annual general meeting.

However, even with this requirement there still exists the risk that the accounting records maintained and the financial statements prepared by management might not be accurate, free from bias and reflect the true financial position and performance of the company. The companies Act therefore goes further to require that management must have the financial statements subjected to an independent examination and a report issued to the shareholders as to whether the financial statements show a true and fair view. This therefore creates the need for an audit. The auditor carries out this independent examination. To ensure independence of the auditor the companies Act gives the power of appointment and removal of the auditor from office to the shareholders.

The primary objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework and show a true and fair view. (Financial reporting framework refers to the international accounting standards, provisions of the companies Act and other relevant statutes and legislation). The auditor expresses an opinion as to whether the financial statements give a true and fair view of the financial position and performance of the company.

Note that: an auditor does not certify the financial statements as true and fair but onlyreports his opinion basing on the evidence obtained.

b) Procedures for appointment of auditor

The appointment of a statutory auditor is governed by the Company‘s Act Cap 486.

S.259 (2) provides that ―every company shall at each annual general meeting appointan auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.‖

The auditor‘s appointment thus runs for approximately a year from the moment the meeting ends. This section makes it clear that it is the company (i.e. the members/shareholders) which appoints the auditor(s) and not the directors.

However, in practice it is important to note that there will be occasions where the company is wholly, or mainly made up of director shareholders. Also in most cases the directors; acting as agents of the company will choose or recommend to the shareholders which auditing firm to appoint.

REAPPOINTMENT OF AUDITORS

S.259 (2)‖ a retiring auditor shall be deemed to be re-appointed without any resolutionbeing passed unless: -

a) He is not qualified for appointment; or
b) A resolution has been passed at that meeting (i.e. annual general meeting) appointing somebody instead of him or providing expressly that he shall not be re-appointed; or
c) He has given the company notice in writing of his unwillingness to be re-appointed.

According to this provision of the company‘s Act an appointed auditor is deemed to be automatically re-appointed come the next annual general meeting for another term in office unless any of the three mentioned situations exist.

APPOINTMENT BY REGISTRAR

S.259 (3) —Where at an annual general meeting no auditors are appointed or deemed to be appointed, the registrar may appoint a person to fill the vacancy‖

The directors have the duty of informing the registrar of the failure by the company to appoint an auditor within seven (7) days.

APPOINTMENT BY DIRECTORS

S. 259 (5)-the first auditors of a company may be appointed by the directors at any time before the annual general meeting, and the auditors so appointed shall hold office until the conclusion of that meeting.

In default of appointment, the first auditors by the directors the company may do so. Where the directors have appointed the first auditors, the company may at a general meeting remove such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company. Notice of nomination to be given to the members at least 24 days before the date of the meeting.

Casual vacancies

S. 159 (6) —The directors may fill any casual vacancy in the office of the auditor, but while any such vacancy continues the surviving or continuing auditor(s), if any may act.‖

A casual vacancy may arise out of any of the following reasons;
a) Death of the auditor
b) Incapacitation
c) Resignation

i.e. a casual vacancy arises when any of the above circumstances arise leaving the office of the auditor vacant before the expiry of the term in office under the contract.

The directors of the company may fill a casual vacancy in the office of the auditor.

c) The responsibilities of the directors in relation to the accounting function of the company are as follows:-

1. To safeguard the company‘s assets and to prevent fraud and errors in the company.
2. To ensure that the company keeps proper accounting records.
3. To prepare annual financial statements to show the results of the company for the year and the state of affairs of the company at the balance sheet date. (Must show a true and fair view).
4. To deliver to the registrar of companies a copy of the company‘s audited financial statements within seven months of the end of the accounting year.
5. To set up an ICS in the company to ensure that all the above are carried out.

d) Duties/responsibilities of the auditor

- To report to the shareholders on whether the financial statements of the company (or group of companies) show a true ad fair view or present fairly and have been properly prepared in accordance with the requirements of the companies Act i.e. the profit and loss account and the balance sheet show a true and fair view.

- To consider whether the information on the directors report is consistent with the financial statements and if not, to state the fact in his report.
- To report whether proper accounting records have been kept by the company
- To report whether proper returns adequate for their audit have been received by branches not visited by them
- To report whether the company's balance sheet and its profit and loss account are in agreement with the acting records
- To report whether he has received such information and explanations s he thinks necessary for the performance of his duties.

QUESTION THREE

a) **Fraud refers to the intentional misrepresentation of financial information by one or more individuals amongst management, employees and third parties.**

Fraud involves: -

1. Manipulation, falsification or alteration of records or documents. For example where an employee alters the amount payable to a supplier as per the invoice with the objective of obtaining a financial gain.
2. Misappropriation of assets. For example where cash collections are misappropriated and the amount is not recorded.
3. Suppression/omission of the effects of transactions from records/documents. For example failure to recognise liabilities in the accounting records.
4. Recording and transactions without substance.
5. Misappropriation of acting policies.
6. Reporting to management where any frauds have been detected or suspected.
7. Providing recommendations through the management letter on ways of strengthening the system to minimise the potential frauds.

b) The primary responsibility for the prevention and detection of frauds and errors rests on management of the company.

Auditors should assess the risk that fraud/error may cause the financial status to contain material misstatements and should enquire of management as to any fraud or error that has been discovered based on that risk assessment, which will involve consideration of the integrity of the client, unusual pressures on the entity, unusual transactions and problems in obtaining sufficient appropriate evidence, the auditor should design appropriate tests.

Auditors accept representations and documents as genuine unless evidence to the contrary, appears but conduct their work with an attitude of professional scepticism.

An auditor should design audit procedures to obtain reasonable assurance that those frauds and errors, which are material, have not occurred or if they have occurred they have either been corrected or properly disclosed in the financial statements.

Due to the inherent limitations of an auditor, there is an unavoidable risk that some material misstatements will not be detected even though the audit is properly planned and performed. This is because fraudulent conduct is often deliberately concealed and all internal controls and audit procedures are subject to inherent limitations. Any accounting and internal control system has inherent limitations which means that it may be ineffective against frauds such as collusion between employees and management override of controls.

If the auditor detects any fraud regardless of the materiality he has a duty to report this to management.

c) The auditor should plan his work with a reasonable expectation of detecting any material frauds or errors. He should approach his work with an attitude of professional scepticism. He should be on the look out for any factors that increase the risk of fraud or error. Where fraud is suspected the auditor should carry out additional audit procedures as appropriate to dispel his suspicion.

Procedures where fraud or error is suspected: -

1. Consideration of potential effects: - If the auditor believes that the indicated fraud or error could have a material effect on the financial status, he should perform modified or additional procedures.
2. Modified or additional procedures: - This will depend on the nature of the fraud indicated the likelihood of its occurrence and the likely effect on the financial status where such audit procedures do not dispel the suspicion of fraud or error. The auditor should discuss the matter with management and consider if it has been properly reflected in the financial status.
3. Approaching his work with seasonal scepticism.

Implications for the audit

Where fraud is discovered the auditor should report this to management and also consider the implications on other evidence obtained from management. Where the fraud discovered is material the auditor should ensure that the effects are properly reflected in the financial statements. Auditors should consider the effect of the fraud or error on their preliminary risk assessment and on the reliability of management responsibility especially where senior management is involved.

QUESTION FOUR

a) A letter of representation is written by the directors of a company to the auditors of that company normally towards the end of an audit before the auditor signs his audit report. The letter confirms verbal representations made by the directors during the audit as well as providing audit evidence on areas where other audit evidence is not available e.g. where a company settles a legal claim out of court, the directors would then provide representations to the auditor that they know of no other claims on the company in this area.

In addition the letter of representation will serve the following functions:-

- It reminds the directors of their duties concerning the financial statements. In the letter the directors acknowledge their responsibility for their preparation of the financial statements event though the auditor may have assisted in this area.
- It provides the auditor with a further source of audit evidence to corroborate other information obtained.

b) Example of a letter of representation

Set out below is an example of a letter of representation, which relates to matters, which are material to financial statements and to circumstances where the auditor cannot obtain independent corroborative evidence and could not reasonably expect it to be available. It is not intended to be a standard letter because representations by management can be expected to vary not only from one enterprise to another but also from one year to another in the case of the same client.

Dear Sirs,

We confirm to the best of our knowledge and belief and having made appropriate enquiries of other directors and officials of the company, the following representations given to you in connection with your audit of the company"s financial statements for the year ended 31 December. …

(b) We acknowledge as directors our responsibility for the financial statements which you have prepared for the company. All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the company have been properly reflected and recorded in the accounting records. All other records and related information including minutes of all management and shareholders" meetings have been made available to you..

(c) The legal claim by Mr. G.H. …… has been settled out of court by the company paying him Sh. 638,000. No further amounts are expected to be paid, and no similar claims by employees or former employees have been received or are expected to be received.

(c) In connection with deferred tax not provided, the following assumptions reflect the intentions and expectations of the company/

i) Capital investment of Sh.260,000 is planned over the next three years.

ii) There are no plans to sell revalued properties

iii) We are not aware of any indications that the situation is likely to change so as to necessitate the inclusion of a provision for tax payable in the financial statements.

(d) The company has had at no time during the year any arrangement, transaction or agreement to provide credit facilities (including loans, quasi-loans or credit transactions) for directors nor to guarantee or provide security for such matters

c) The letter of representation is considered reliable audit evidence because:-

It provides written confirmation of managements representation. It therefore has more credibility than oral evidence especially in instances where the management representations in the letter appear reasonable and consistent with other sources of audit evidence.

The reliability if the evidence will also depend on whether the individuals making the representations can be expected to be informed on the matter.

If the letter of representation is contradicted by other evidence, the auditor should investigate the circumstances and where necessary, reconsider the reliability of other representations made by management.
The Company's Act make it an offence to give the auditor false information thus the management is bound to provide the auditor with information that is true.

(d) Management maybe unwilling to sign letters of representations. If management declines the auditor should inform management that he will himself prepare a statement in writing setting out his understanding of any representations that may have been made during the course of the audit and then sends this statement to management with a request for confirmation that the auditor‘s understanding of the representation is correct.

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

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

QUESTION FIVE

Tutor"s hint: What your answer should demonstrate is that the date the detailed audit workis finished is irrelevant from the viewpoint of the auditor‘s responsibilities. What matters is the date the audit report is signed. The position after the audit report is signed may appear to be complicated, but you do need to be aware of the various possibilities and what the auditor should do in each set of circumstances. In (c) your answer should list various ways in which auditors can actively obtain evidence; they should not just rely on the representations of the directors.

Examiners comment: Candidates lost marks through discussing accounting forsubsequent events rather than audit. Few candidates understood that auditors only have responsibilities after the audit report is signed if they become aware of any further subsequent events. Answers to (c) were poor.

(a)

(i) Between the year-end and the end of the performance of detailed audit work, auditors should identify and detect all material subsequent events which take place in that period. Such events which are non-adjusting should be disclosed in the notes to the accounts of the company, whereas all adjusting events should be incorporated in the accounts.

(ii) As the auditors‘ responsibility extends to the date on which they sign their report (which should be the same day as the directors signed the accounts), it follows that they must obtain reasonable assurance up to than date in respect of all significant events. Auditors should ensure that any such significant events are appropriately accounted for or disclosed in the financial statements. If not, a qualification of their report may be necessary. In other words, the auditors‘ responsibility is the same as it was during the detailed audit work.

(iii) Auditors‘ responsibilities after the date of the audit report are not as clear cut as they are in the period prior to the date of the audit report. After the date of the audit report auditors do not have a duty to search for evidence of subsequent events. However, auditors should ask the directors to let them know if any material post balance sheet events occur during this period. If, before the AGM they become aware of information which might have made them give a different audit opinion had they known of it at the time, they should act as follows:

1. They should discuss the matter with the directors, carry out further procedures to obtain sufficient audit evidence and then consider whether the financial statements should be amended by the directors.

2. If the directors are unwilling to take action which the auditors consider necessary to inform the members of the changed situation, auditors should consider exercising their statutory rights to make a statement at the general meeting. They should also consider taking legal advice on their position.

3. If the directors wish to amend after the auditors have signed their report, the auditors will need to consider whether the proposed amendments affect their report. The audit report should not be dated before the date on which the amended financial statements are approved by the directors. Auditors should follow the procedures for auditing events after the balance sheet date before making their report on the amended financial statements.

(iv) If auditors become aware of subsequent events during this period that may affect the accounts, they should consider whether to withdraw their audit report. Legal advice may be required. As in (iii) the auditors should consider making a statement at the annual general meeting.

If the directors do decide to change the accounts, further post balance sheet work will be necessary to cover events up to the revised date of the audit report. In the later audit report, the auditors should refer to their original audit report, and to the note in the accounts which should give details of the changes.

(v) Auditors have no responsibility for identifying subsequent events during this period. If however the directors find material errors in the accounts and inform the auditors, similar procedures to those used in (iv) will be needed.

(b) The audit work for subsequent events will normally be concerned with balance sheet values at and after the year-end. The following procedures will be carried out.

ii) Fixed Assets

1. Check for any sales or proposed sales after the year-end which may mean a write down to net realizable value at the year-end.

2. Consider obsolescence of fixed assets, for example plant used to make a discontinued line, which might only become apparent after the year-end.

iii) Stock

1. Check post year-end selling price of major items of stock and compare to value in year-end accounts. Consider write-downs to net realizable value.

2. Consider the possible existence of obsolete, damaged or slow moving stock and the consequent value of any write down.

3. Perform a (limited) stock-take after the year-end if the existence of all stock is not known for certain.

iv) Debtors

1. Check sales ledger cash received after the year-end to determine realisability of debtors and highlight doubtful debts.

2. Take doubtful debts out of the provision and consider writing parts of the provision off for which no money has been received.

3. Review trade press and correspondence and consult the sales manager about any major customers who have become insolvent recently.
4. Check the issue of credit notes and return of goods after the year-end to determine the provision for credit notes required in the accounts.

v) Cash at bank

1. Check that outstanding items on the bank reconciliation have cleared promptly after the year-end (to spot teeming and lading and late payment to creditors).

2. Write back any stale cheques not cleared (over 6 months old).

3. Check all material payments and receipts around the year-end to check the completeness of both accruals and prepayments (including NI and PAYE sundry creditors).

vi) Trade Creditors

1. Check reconciling items on suppliers' statements have cleared promptly after the year-end.

2. If a creditors' circularisation has been carried out then verify balances by examining post year-end payments, in cases where there was no supplier's statement and no reply.

vii) Going concern problems and other matters

1. Check profit and cash flow forecasts for evidence of future liquidity.

2. Review management accounts and reports after the year-end.

3. Review board minutes after the year-end.

4. Request any information on subsequent events and going concern matters from the directors and check their information.

5. The directors should also state they have given all such information in the letter of representation.

viii) Non-adjusting events

Look in board minutes and cash book for any matters which are non-adjusting but which should be disclosed in the accounts, for example, major sales of fixed assets, accidental losses and issues of shares and debentures.

d) I will check whether there have been any material subsequent events in this period, particularly if there is a significant delay between completing the detailed audit work and signing the report. I will not undertake such detailed enquiries as in (b) above, but I will perform the following procedures:

i) Ask the management or directors if any further material events have occurred which might affect my opinion on the accounts.

ii) Review the latest board minutes, reports and managements accounts issued since the end of the audit.

iii) Any matters which were uncertain at the end of the audit should be reviewed again to establish an outcome and any effect on the accounts. Examples would include doubtful debts, contingencies and stock obsolescence (perhaps due to new developments).

Consider any matters which have arisen in the industry or the economy which might affect the company.

QUESTION SIX

(a) Tests of control are tests to obtain audit evidence about the effective operation of the accounting and internal control systems, that is, that properly designed controls identified in the preliminary assessment of control risk exist in fact and have operated effectively throughout the relevant period.

Substantive procedures are tests to obtain audit evidence to detect material misstatements in the financial statements. They are generally of two types:

(a) analytical procedures
(b) other substantive procedures, such as tests of details of transactions and balances, review of minutes of directors meetings and enquiry.

Walk through tests involve tracing one or more transactions through the accounting system and observing the application of relevant aspects of the internal control system.

(b) (i) The first stage in any audit should be to determine its scope and the auditors general approach and preferably to draw an audit programme.

(ii) The objective of the next stage of an audit is to determine the flow of documents and the extent of controls in existence within the clients systems.

Determining the mechanics of a system is frequently achieved by performing walk through tests.

(iii) The next stage is to prepare a comprehensive record (using ICQs and flow charts) of the clients systems to facilitate the evaluation of those systems.

(iv) Having confirmed the clients systems auditors should then evaluate the systems after which they will be able to recommend improvements to the systems as required.

(v) If the controls are assessed as being effective, it will be necessary to select and perform tests designed to establish compliance with the systems. It is necessary for the auditors to check that the controls are as effective in practice as they are on paper by carrying out tests of controls. The conclusion drawn from the results of a test of control may be either:-

(i) That the controls are effective in which case the auditors will only need to carry out restricted substantive procedures.
(ii) That the controls are ineffective in practice, although they had appeared strong in theory, in which case the auditors will need to carry out more extensive substantive tests.
(iii) If the controls are assessed as being ineffective, the auditors should move straight to a programme of full substantive procedures. This tests are designed for two purposes:

a) To support the figures in the financial statement
b) Where errors exist, to assess their effect in monetary terms

(c) The major question which internal control questionnaires are designed to answer is ‗How good is the system of controls?' Its primary purpose being to evaluate the system. One of the most effective ways of designing an internal control questionnaire is to phrase the question so that all the answers can be given as YES or NO, when a NO, will indicate a weakness in the system.

Whereas internal control questionnaires tend to ask separate questions in relation to each individual aspect of internal control, internal control evaluation questionnaires tend to concentrate on key questions.

Internal control questionnaires and internal control evaluation questionnaires both have an important role to play in the evaluation of systems. ICQs have the added advantage that they can infact help to document the system as well, whereas internal control evaluation questionnaires are perhaps more useful in focusing attention on the more important aspects of control systems.

QUESTION SEVEN

a) The original concept of an audit trail was to print out data at all stages of processing. Computer auditing methods have now cut out much of this (a bonus, time consuming,) working and make use of:

i) a more limited audit trail
ii) efficient control total
iii) use of enquiry facilities
iv) audit packages
v) file dumps

This can however mean that auditors have difficulty tracing individual transactions within the system.

Auditing through the computer

This involves an examination of the detailed processing routines of the computer to determine whether the controls in the system are adequate to ensure complete and correct processing of all data.

Audit test data consists of data submitted by the auditors for processing by the enterprises computer based accounting system either during a normal production run or during a special run at a point in time outside the normal cycle.

Audit software comprises computer programs used by the auditors to examine an enterprise computer files. Types of audit software include:

i) Package programs consist of prepared generalized programs for which the auditors will specify their detailed requirements by means of parameter or supplementary program code.

ii) Purpose written programs involve the auditors satisfying their detailed requirements by means of program code specifically written for the purpose.

iii) Utility programs consist of programs available for performing simple functions, such as sorting and printing data files.

b) Analytical procedures are substantive process which can be useful at most stages of the audit. As well as confirming figures directly (such as the PAYE due on salaries for a period) they may also be used to give additional comfort where other audit tests and other figures are also available.

The analytical procedures will not guarantee that certain transactions have been processed, but they will give some assurance that the records are accurate and complete.

Analytical procedures compare figures, trends and ratios to one another, to prior periods and to budgeted or forecast figures where variations occur from what is expected then investigations can be made to establish the reasons.

c) The auditors can use audit software for analytical procedures in the following ways:-

i) It can read computer files and extract data, such account balances, agreeing analysis for stock and debtors etc.

ii) If the relevant information is on the computer, the audit software can compare current results to prior year or to budget.

iii) Other computational aspects would be the calculation of days sales in debtors or days purchases in stock and creditors.

iv) The audit software can calculate any amount of variance, trends and ratios. The auditor must still analyse what the software produces which will involve them using professional judgment in analyzing the figures.

d) (i) Debtors turnover ratio = $\frac{Sales}{Debtors}$

A decrease in debtors turnover means that debtors have risen faster than sales. This could be due to:-

- Changes in sales mix
- Changes in credit terms
- Worsening economy or industrial conditions

- Changes in credit control department staffing
- Changes in customers
- Teeming and lading frauds taking place
- Cut-off errors
- Sales may have declined suddenly

Audit Implications

i) Recoverability of debtors becomes more doubtful as age of debtors increases. This could raise the need to increase the provisions for doubtful debts.

ii) Questions as to the completeness of sales ideally a growth in debtors should be a reflection of a growth in sales.

ii) Stock turnover ratio = $\frac{\text{Cost of sales}}{\text{Stock}}$

Possible reasons for the decrease:

A new method of valuing stock may have been adopted
- Sales may have declined suddenly
- Cut-off errors
- Increase in stock quantities perhaps due to bulk buying to obtain discounts
- Stock values and amounts incorrectly calculated
- Changes in types of stock held due to change in sales mix

Audit Implication

i) Dead/ slow moving stock. There is need to review stock and possibly create a provision.

QUESTION EIGHT

Tutor"s hint: The audit of stock is an important subject in this paper. Remember that thestock-take attendance gives the auditor assurance of existence of stock, not ownership or value. In (a) think of the information the auditor needs, and then ask how it will be obtained. Key elements in (b) are supervision, who caries out the count, how the count is to be carried out and recorded, and special arrangements for certain stock.

(a) The work I will carry out prior to the commencement of the stock-take will be as follows:

i) Review previous year‘s audit working papers and discuss any developments in the year with management.
ii) Obtain and review a copy of the company‘s stock taking instructions.
iii) Arrange attendance at stock count planning meetings, with the consent of management.
iv) Gain an understanding of the nature of the stock and of any special stock taking problems this is likely to present, for example scrap in piles.
v) Consider whether specialist involvement is likely to be required as a result of any circumstances noted in (iv) above.
vi) Using the results of the above steps, plan for audit attendance by appropriately experienced audit staff.
vii) Consider the impact of internal controls upon the nature and timing of the stock taking attendance.

viii) Discuss with the management the extent to which each garment is considered complete at each stage of the manufacturing process.

(b) The first step in checking that the company's staff have accurately recorded the stock will be to examine the stock taking instructions issued to stock taking staff. This will involve checking that the following procedures are in place:

i) Supervision of the planning and execution of the stock-take by sufficient senior and qualified personnel drawn from various departments: at least some of the officials should not normally be involved with the custody of stocks.
ii) Tidying and marking stock to facilitate counting of items of stock. The whole of the stock taking area should be divided into sections for control purposes.
iii) The serial numbering and control of the issue and return of all the rough count records, and their retention.
iv) Systematic carrying out of counts to ensure coverage of the whole stock.
v) Arrangements for the count to be conducted by at least two people, with one counting and the other primarily to check the count, or alternatively for tow independent counts to be carried out; and for any differences arising to be investigated and resolved.
vi) Stock sheets being complete in ink and being signed by those who carried out and checked the count.
vii) Information to be recorded on the count records. (normally this will include the location and identity of the stock items, the unit of count, the quantity counted, the condition of the items and the stage reached in the production process).
viii) Restriction and control of the production process and stock movements during the count.
ix) Identification and segregation of damaged, obsolete, slow moving, third parties' stocks and returnable stocks, so that these can be properly accounted for and recorded.
x) Recording the quantity, condition and stage of production of all the work in progress for subsequent checking with the costing and stock records.
xi) Co-ordination of the count with cut off procedures so that documentation concerned with the flow of goods can be reconciled with the financial records. For this purpose, last numbers of goods inwards and outward records and of internal transfer records should be noted.
xii) Reconciliation with the stock records, if any and identification and correction of differences.

(c) The following work should be carried out at the stock-take:

i) Carry out a series of test counts between the stock and the count records and vice-versa. Attention should be given to high value stocks.
ii) Obtain information about the stock's condition, age, usage and, in the case of work in progress, its stage of completion.
iii) In order to ensure that cut-off stock is correct, the following procedures should be carried out:
   1. Make a record during the stock taking attendance of all movement notes relating to the period, including:
      - All inter-departmental requisition numbers;
      - The last goods received note and dispatch note prior to the count;
      - The first goods received note and dispatch note after the count.

2. Observe whether correct cut-off procedures are being followed in the dispatch and receiving areas. Discuss procedures with company staff performing the count to ensure they are understood.
3. Ensure that no goods finished on the day of the count are transferred to the warehouse.

(iv) Finally the auditors should:

1. Conclude whether the stock taking has been properly carried out and is sufficiently reliable as a basis for determining the existence of stock;
2. Consider where any amendment is necessary to their subsequent audit procedures; and
3. Try to gain from their observations an overall impression of the levels and values of stocks held so that they may, in due course, judge whether the figure for stocks appearing in the financial statements is reasonable.

MOCK THREE

QUESTION ONE

(a) Reliance on work of internal auditors

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

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

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

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

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

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(b) Information required

(i) The information required to determine the extent of external audit reliance on internal audit's will be:
- Internal audit's systems documentation (the work on information systems and finance may include documentation of the company's accounting and internal control systems);
- Internal audit's planning documentation, which may cover a risk analysis, tests of controls and substantive procedures;
- The results of tests of control and substantive procedures;
- Documentation on the four-year review of internal controls, particularly in relation to the finance and information services functions.

(ii) The external auditors should ask to see all documentation relating to the work performed by internal audit on information services restructuring during the year because the external auditor's assessment and testing of systems will be split into two parts, pre- and post-restructuring.

(iii) Other documentation requested will include internal audit's operating procedures manuals and documentation relating to the recruitment, training and development of internal audit staff, and management responses to internal audit recommendations. This information is required to enable the external auditor to form an opinion on the competence and effectiveness of the internal audit function.

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

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

– Do not properly plan or document their work, or if management does not act on (or at least respond to) recommendations made;
– Do not perform work relevant to the external auditor.

(ii) It will also not be possible to rely on internal audit if internal audit is insufficiently independent within the organisation, i.e. where internal auditors have insufficient operational freedom, where they are reporting to those who control the functions that they work on, or where they are reporting on their own work.

(d) External auditor work

(i) External auditors will wish to perform work independently, regardless of internal audit work, in all areas that are material to the financial statements. For immaterial areas in which internal audit work can be shown by testing and review to be adequate, it may be possible to rely on the work of internal audit without performing any other work.

(ii) Areas material to the financial statements are likely to be long and short-term leasing receivables and inventory. Leases may be complex and the auditors will wish to ensure that accounting policies are appropriate and that they have been properly applied. The valuation of inventory will have a direct effect on the profit for the period. This is an area that is easy to manipulate and external auditors will wish to ensure that this has not happened.

(iii) External auditors will also wish to perform their own risk analysis and final review of financial statements in order to ensure that no high risk areas have been overlooked.

QUESTION TWO

(a) Internal controls

(ii) Controls contributing to the orderly and efficient running of the business, safeguarding the assets and adherence to management policies would include the following:

- Physical controls over access to the assets such as the locking of doors and the maintenance of an appropriate fire and flood resistant environment;
- Insurance against disaster and contingency plans;
- The use of passwords for access to computers and plant and equipment;
- The numerical or other tagging of all equipment, referenced to an asset register;
- Performing periodic asset audits;
- Internal regulations requiring staff who take equipment such as laptops and motor vehicles home to ensure that they are secure, and prohibiting staff from using their own software on company equipment;
- The maintenance of firewalls and virus checking software.

(iii) Controls contributing to the prevention of fraud and error, and the completeness and accuracy of the accounting records would include the following;

- The preparation and monitoring of capital expenditure budgets together with authorisation of capital expenditure,
- Disposals and depreciation rates by independent persons at an appropriate level within the organisation who do not have day-to-day responsibility for the related records or assets;
- The maintenance of an asset register that is reconciled to the general ledger and the assets themselves;
- The periodic checking and review of asset lives, and fully depreciated assets, to ensure that assets are being depreciated correctly, over an appropriate period of time.

(b) Description

(i) Judgement and statistical sampling

Judgement sampling uses the auditor's judgement to select the number of items to be tested, which items to be tested, and to interpret the results. Statistical sampling uses probability theory to do the same. Some judgement is always used in statistical sampling in the assessment of materiality and in the determination of what constitutes tolerable error, for example.

(ii) Representative sample

A representative sample is one whose characteristics are the same as, or similar to, the characteristics of the population as a whole. All sample selection methods attempt to select samples that are representative.
For example, a sample of invoices that have not been properly authorised in 5% of cases will be representative of all invoices if the population as a whole also has around 5% of invoices not authorised.

(iii) Tolerable error

Tolerable error is the maximum error that the auditor is prepared to accept and still conclude that the audit objective has been achieved.

For example, in relation to receivables, the auditor may be prepared to form the conclusion that receivables are not materially misstated if sampling shows that the receivables population has a value that is within plus or minus, say, 5% of the figure in the financial statements.

(iv) Different methods of sample selection

Random selection requires the use of random number tables in order to select a representative sample.
Haphazard selection may be deemed to approximate to random selection provided that no bias is displayed.
Interval (or systematic) selection involves taking every *n*th item, starting at random. Monetary unit sampling is also a form of systematic selection.
Block selection methods (taking one full part of the population) will probably not result in a representative selection.

Block selection might involve obtaining confirmation of receivables from one region of the country only, for example.

NB: Only two examples are required.

(v) Extrapolation of errors

Errors found in a sample are extrapolated across the population as a whole, in order to enable the auditor to form a conclusion on whether the population is materially misstated. It is important to remember that there is not necessarily a direct, linear relationship between errors in samples and errors in the populations from which they are drawn.

QUESTION THREE

a) Why external auditor objectivity may be, or appear to be, threatened

(i) Undue dependence

If the auditor depends, or relies on a particular client or group of connected clients because the firm takes a large part of its fee income from the client, the auditor may be less likely to challenge accounting policies or disclosures proposed by the client, for fear of upsetting them. This typically happens when the firm is small, but the client is large.

Where the firm feels that an audit qualification may be necessary, it may be reluctant to issue it for fear of losing the client and the fee income. This applies regardless of whether the fee income is audit fee income or income for other work.

The issue is important because if the auditor does not issue a qualified audit report where appropriate, the firm may be sued for negligence. Where a large client is involved, the firm's professional indemnity insurance may not cover the claim.

(ii) Financial interest

Where a partner or member of staff in a firm (or the firm itself) holds shares in a client, they have an interest in the client's performance. If the client performs well, the value of the shares may rise. A qualified audit report is not usually associated with good performance and the firm may therefore be reluctant to issue one where appropriate. This is important for the reasons noted above.

Even if there is no question of a qualified audit report, there may be a temptation to help the client present the results in the best possible light, instead of presenting a balanced view.

There is also a financial interest where partners, staff or the firm make loans to, or guarantee the borrowings of the client or *vice versa*. Significantly overdue fees of amounts that are significant to either auditor or client are akin to loans.

(iii) Family or other close personal or business relationships

Where there are family or other close personal or business relationships between client and audit firm, the individuals concerned may try to influence the firm in its dealings with the client in order to protect the family or personal relationship, or the mutual business interest.

If, for example, an audit partner is married to the finance director of a client, it is less likely that the client will receive a qualified audit report than it would be if the relationship did not exist. This is important in any case but more so where the effect of a qualified (or modified) audit report is likely to result in, say, withdrawal or non-renewal of banking facilities which might result in the business ceasing to be a going concern. If the firm does not issue a modified audit report in such circumstances, the firm may be exposed to claims of negligence by the bank.

If there are close business relationships between client and auditor, both parties have an interest in each other's performance and there is therefore a double pressure to present the results in the best possible light and not to issue a qualified audit report.

(iv)Other services

Many audit firms provide their audit clients with services other than audit services. It is very common for to provide their very small audit clients with accountancy services, for example.

Other services that can be provided include tax, management consulting, IT and human resources advice. Some firms not only provide consulting advice, but also perform IT and other functions for some of their clients.

There are two threats to objectivity where other services are provided. Firstly, the firm may find that it is reporting on a system that the firm itself has set up or advised on, or reporting on information that the firm itself has prepared. This means that it is reporting on its own work and it may be difficult to be objective in such circumstances. Secondly, the fee income from other services may well exceed the fee income from the audit and the client may pressure the firm to give an unqualified audit report by threatening to take the other services to another firm if a qualified report is given.

(b) Internal controls

(i) Receipt, processing and recording

- All orders taken should be recorded on a pre-numbered multi-part document generated by the computer. One part might be a copy for the customer, one might form the invoice, one might be for the dispatch department and one might be retained for accounts receivable ledger purposes.
- Manual or computer systems should perform checks on the completeness of the sequence of pre-numbered documents at various stages. Any documents unaccounted for should be traced and investigated.
- The computer system should apply the credit limits set by the credit controller and the system should reject any orders that exceed customer credit limits at the point at which the order is taken, so that the customer can be advised. Any override of credit limits should be authorised by the credit controller.
- From time to time, there should be an independent check to ensure that the credit limits within the system are being properly calculated and properly applied to individual transactions. Similar considerations apply to prices maintained within the system. The computer system should also reject any order for which there are no flowers available so that orders cannot be taken for flowers that cannot be delivered.
- All invoices should be posted to the sales daybook, the accounts receivable ledger and the accounts receivable control account automatically by the system and the accounts receivable ledger and the accounts receivable control account should be reconciled each month in order for sales and receivables records to be kept up to date.
- There should be controls in place to deal with credit notes and other discrepancies involving the price, type or quality of flowers delivered in order to maintain the accuracy of records and customer goodwill.

(ii) Collection of cash

- At the end of each period, the system should produce a list of overdue receivables. There should be procedures for chasing these customers and for putting a ‗stop' on accounts where amounts are significant in order to control bad debts;
- When bank transfers are received from customers, they should be input into the system and matched with individual transactions and controls should ensure that the correct amounts are allocated to the correct customers and transactions.
- An exception report should be produced for any unallocated bank transfers. Exceptions should be promptly investigated. This will ensure that receivables information is accurate and up to date and that customers are not chased for amounts that have been paid
- Bank reconciliation should be performed on a monthly basis in order to ensure that the company's cash records are complete, accurate and up to date.

QUESTION FOUR

(a) Company A

(i) 10-year bank loan and bank overdraft

- Authorisation for the loan and overdraft should be checked to the minutes of a board or other relevant meeting.
- The details of contracts with the bank and any relevant correspondence should be examined. Any covenants restricting the use of securities held against the loans should be examined and the client's compliance with the covenant checked. If covenants have not been complied with, the implications for the company and the financial statements should be considered.
- The response to the year-end bank confirmation should be examined. It should provide details of the amounts outstanding and the amounts paid and payable during the year in terms of both interest (loan and overdraft) and capital (loan only). In both cases, details of any security held for the loan and overdraft should be requested.
- Analytical procedures should be applied to the interest paid in the income statement, and to the interest and capital paid and outstanding at the period-end for the loan.
- The bank reconciliation should be checked to ensure that the overdraft has been properly reconciled to the records, and that there are no old or significant outstanding amounts that need to be adjusted for.
- The amount payable at the year-end should include amounts payable in one year, which should be included in current payables, and amounts payable in over one year. The notes to the financial statements should also disclose amounts payable in over five years.
- The auditors should ensure that appropriate disclosures are made in the notes to the accounts in accordance with legislation and International Financial Reporting Standards. In particular, where assets are held as security, this should be disclosed in the notes relating to the assets.

(ii) Expense accruals

- If accruals are material to the financial statements, more evidence will be required than if they are not. If accruals are not material, analytical procedures may be sufficient audit evidence;
- A schedule of accruals should be obtained and checked for arithmetical accuracy. Individual accruals should be reviewed by comparison with prior periods and budgets and any significant variations investigated, particularly if accruals have been made in previous periods but have not been made in the current period;
- The amounts paid after the period-end should be checked to the bank statement and the calculation of a sample of amounts payable should be checked for accuracy, by reference to subsequent invoices;
- If any accruals are payable more than one year after the balance sheet date, an appropriate split should be made in the balance sheet.

(iii) Trade payables and purchase accruals

- The nature and extent of testing will depend on the quality of controls over trade payables, as evidenced by interim testing of internal controls. Evidence in relation to the completeness of trade payables and accruals is important, but not always easy to obtain;
- The auditors should form an opinion as to whether direct confirmation of trade payables is likely to provide valuable audit evidence by discussion with the client.
- It is sometimes possible to rely on supplier statement reconciliations instead of direct confirmation, but this depends on the availability of supplier statements. Where supplier statement reconciliations are performed, it is important to be aware of the possibility of forged or altered statements – originals rather than copies should be examined. Some combination of supplier statement reconciliations and direct confirmation is often used.

- If a decision to obtain direct confirmation of trade payables is taken, the client‗s co-operation is required in authorising the requests and in helping the auditors sort out any differences between the balances recorded by the company and those recorded by suppliers.
- Particular care should be taken if there are material balances for which there are no supplier statements or no response to a request for confirmation. Consideration should be given to telephoning the supplier in this case.
- Analytical procedures should be applied to the ageing and level of trade payables by comparison with prior periods;
- Variations should be investigated and substantiated, with particular attention being paid to old outstanding amounts;
- A representative sample of individual trade payables should be traced back through the system from the schedules supporting the financial statements to the ledgers, daybooks and source documentation to ensure that the amounts recorded are accurate. The size of the sample will depend on the auditor‗s assessment of risk in this area;
- A schedule of purchase accruals should be obtained and checked for arithmetical accuracy and completeness by comparison with prior periods and invoices received after the period-end. As with trade payables generally, there is a risk of unrecorded items.
- Both trade payables and purchase accruals should be tested for the accuracy of cut-off by reference to invoices and inventory records for an appropriate period each side of the period-end;
- A review of correspondence with trade creditors should be performed and any legal department should be requested to provide details of disputes with creditors;
- If any trade payables are payable more than one year after the balance sheet date, an appropriate split should be made in the balance sheet.

(b) Company B

(i) Provisions for manufacturing warranty claims are heavily dependent on the judgement of directors. The auditors should establish how the directors have arrived at the provision and assess it for reasonableness in the light of previous provisions and claims. More work will be required if there has been a significant discrepancy between provisions and claims in the past and more work will be required if the company does not have significant experience in dealing with this type of warranty claim.

(ii) IAS 37 ‗Provisions, Contingent Liabilities and Contingent Assets‗ states that a provision is a liability of uncertain timing or amount which should only be recognised when there is a present obligation, as a result of a past event, and where it is probable that an outflow of resources will be required to settle the obligation, the amount of which can be reliably estimated. It would appear that the warranty claim fits this description.

(iv) Auditors should check the calculation of the provision for arithmetical accuracy and to ensure that it is calculated in accordance with the method determined by directors. This can be achieved by reviewing the level of claims and payments both before and after the period-end.

(v) If there has been a change in the method of calculating the provision, the auditors should ensure that it is reasonable in the light of evidence available and that it is properly disclosed, if material. If there has been a change in the product mix to which the warranty applies, this should also be considered, particularly if there are new, relatively untried products which carry a higher risk of claims in the first few years.

(vi) If any previous provisions have been released in the current period because of over-provisions in previous periods, the auditors should ensure that the amount released is reasonable, and is properly disclosed in the income statement as appropriate. ‗Soft‗

provisions such as these can be manipulated by the client and particular care therefore needs to be taken.

(vii) A review of correspondence with customers should be performed and any legal department should be requested to provide details of disputes with customers relating to claims.

QUESTION FIVE

(a) Management representations Evidence

(i) Auditors obtain written representations from management on material matters where other sufficient appropriate audit evidence cannot reasonably be expected to exist. ISA 580 ‗Management Representations' deals with this subject.

(ii) Such matters might include confirmation that all related party transactions have been disclosed in the financial statements and confirmation of all matters that rely principally on the exercise of judgement by directors – such as ‗soft' provisions. The letter also usually includes confirmation that all matters occurring since the balance sheet date that should be brought to the attention of auditors have been brought to their attention, and that all of the accounting records have been made available to the auditors.

(iii) Management representations should not conflict with other audit evidence. If they do, the matter should be investigated and resolved.

Practical difficulties

(iv) In practice, it is not always easy to obtain a signed management representation letter. The letter should be addressed from the client to the auditor, but it can take the form of a letter from the auditor to management that is acknowledged by management, or signed minutes of a board or similar meeting.

(v) If management refuses to provide representations, this may be grounds for a qualification of the audit report on the basis of a limitation in the scope of the audit. However, this is an extreme step and auditors will always discuss with directors alternative wordings that will be acceptable to them before considering qualification of the audit report. There may be genuine uncertainty on the part of management as to the reasonableness of the representations that auditors request them to make.

Alternative evidence

(vi) Unfortunately, because of the content of these letters, there is very little alternative evidence; that is why the letter is requested in the first place.

(vii) Auditors need to think carefully about the content of the letter if management refuses to sign altogether, and consider whether there is alternative evidence, whether the matters are truly material and whether an audit qualification is needed. Auditors can exert some pressure on management to sign by making this threat, in practice.

(b) Direct confirmation of receivables

Evidence

(i) Auditors often seek direct confirmation of receivables to ensure that the amounts stated in the entity's accounts receivable ledger are not overstated. Confirmation also provides evidence in relation to certain frauds and the quality of internal controls.

(ii) Confirmation that an amount is owed is not confirmation that the amount will be paid and auditors need additional evidence on the recoverability of receivables.

(iii) There are two types of confirmation, positive and negative. In the former case, the customer is requested to reply in any case, and the auditor can either insert the balance to be confirmed or the customer can be requested to do so. In the latter case, a reply is only requested if the customer disagrees. This method is only suitable where receivables are well controlled.

Practical difficulties

(iv) The response rate to requests for confirmations is not always satisfactory and repeated requests may be necessary. It is not uncommon for replies to be inaccurate, especially where the amount stated is too low.

(v) Where the customer is requested to insert the balance, the reconciliation can sometimes be very difficult, even with the help of the client, and the customer's assistance may be needed.

Alternative evidence

(vi) Where no reply is received it is important that alternative evidence is obtained on the same balance (and not to test another balance). Where there is a discrepancy between the client's records and the customer's records, the matter should be investigated and resolved.

(vii) Sometimes, the customer can provide a reconciliation, particularly if the matter only relates to timing differences. On other occasions there may be a dispute and a provision may be necessary.

(viii) Alternative evidence for receivables includes payment of the amount after the period-end, a review of contracts and signed delivery notes, and analytical procedures on the ageing of receivables.

(c) Confirmation of inventory held by third parties

Evidence

(i) It is often not possible for auditors to confirm inventory held by third parties by attendance at an inventory count and therefore the only evidence available is confirmation from the third party.

(ii) It is particularly important to ensure that the confirmation is genuine because of the possibility of fraudulent collusion between the third party and the client to inflate inventory and profit figures.

(iii) The reliability of service from the third party and the quality of documentation and correspondence are all taken account of as part of the auditor's risk assessment in this area.

Practical difficulties

(iv) Both the quality and quantity of inventory held should be confirmed. It is common for third parties to use different descriptions or units of measurement in their records to those used by the client and it is necessary to reconcile these items.

(v) It may be possible for the auditor of the third party to provide some evidence in relation to the amounts held.

Alternative evidence

(vi) If the inventory held by the third party is likely to be material, the auditor must consider the possibility of visiting the third party and attending the inventory count.
(vii) The auditor may review and test the controls over the movement of inventory to and from the third party and the related records, in order to reduce the level of substantive evidence needed at the period-end.
(viii) Records that show ‗negative' inventory (more ‗outs' than ‗ins') at either the client or the third party may be indicative of misclassifications, for example.

QUESTION SIX

(a) (i) Internal control objectives

Control objectives include policies and procedures designed by management to:

- Achieve the orderly and efficient running of the business including adherence to internal policies – this would include the regular, accurate processing and recording of payroll payments.
- Safeguard assets – this would include the physical safeguarding of cash and safeguarding money held in bank accounts by means of other controls.
- Prevent and detect fraud and error – fraud and error would include incorrect payments or deductions from the payroll and payments of incorrect amounts for tax and NSSF, payments for work not performed and payments to dummy employees, for example.
- Achieve accuracy and completeness of the accounting records and timely preparation of reliable financial information; this would include making correct payments and deductions from the payroll, correct payments for tax and (NSSF, NHIF), and making payments for work performed only (not to dummy employees, for example), in order that quarterly or half-yearly accounts can be prepared (possibly), but in any case in order that annual accounts can be prepared within the time limits for small companies.

(ii) Internal control environment and control procedures

The control environment relates to:

- Management's overall style in encouraging awareness of the need for good controls, for example.
- The existence of organisational controls such as review of the payroll by an independent person such as the managing director, and the rotation of payroll duties amongst staff responsible for processing it – this helps achieve all of the objectives set out above.
- Segregation of duties and supervisory controls to avoid the misappropriation of cash and to avoid fraudulent collusion to create, for example, dummy employees or to make inflated payments – this prevents the loss of assets and/or inaccurate records.
  Internal control procedures include:
- Limiting direct physical access to the cash, such as the use of a security firm to deliver cash, locking doors to areas where cash is held, keeping cash in a fire-proof safe and the protection of the computer by password controls – this will help safeguard assets and ensure the completeness and accuracy of the records and financial statements.
- Controls over computerised applications, checking the arithmetical accuracy of documents and the maintenance of control accounts – this can be achieved by, for example, the use of timesheets or clockcards, the use of reliable software with programmed controls for the calculation of deductions, and the use of batch and hash totals for information that is input into the computer system – this helps achieve the orderly and efficient running of the
  business and the accuracy and completeness of records and financial statements.
- Approval and control of documents, such as the authorisation of the payroll itself, and authorisation for the bank to make transfers and to deliver cash.

(b) Audit objectives, tests of control and substantive procedures

Objectives	**Tests of control and substantive procedures**
Existence: of assets and liabilities such as cash on hand and in the bank, and of the liability to pay staff and the associated tax and NSSF contributions.	Testing controls over the security of cash to ensure that they are operating effectively throughout the period. Performing cash counts, with reconciliations to the records and observing cash payments to staff, ensuring that appropriate signatures are obtained and that unclaimed cash is promptly re-banked, for example. Making checks on the physical existence of staff to ensure that the related expenses and liabilities are genuine. Checking after date payments to staff and for tax and NSSF contributions.
Occurrence: payroll transactions occurred during the relevant accounting period.	Performing cut off tests to ensure that payroll costs incurred during the period have been recorded during the period by examining entries in the payroll records just before and just after the period end and checking back to source documentation, such as timesheets or clock cards
Completeness: there are no unrecorded assets or liabilities such as cash on hand and in the bank or transactions such as payroll payment.	Performing starters and leavers tests to ensure that staff are not paid before they join the company and are not paid after they leave. This involves checking the payroll for two separate periods and examining entries relating to starters and leavers in the intervening period. Manually checking the accuracy of payroll calculations to ensure that correct payments and deductions are being made in accordance with approved pay rates and approved deduction rates for tax and NSSF. Reviewing evidence of authorisation controls to ensure that the payroll has already been checked.
Measurement: transactions such as payroll payments are recorded at the correct amounts and are recorded in the correct period.	Same as for completeness, above, and checking entries relating to hours or time worked in the payroll to source documentation.
Presentation and disclosure: an item is disclosed and described in accordance with accounting standards and legislation.	Reviewing the financial statements with the aid of a disclosure checklist to ensure that disclosure requirements have been met. Reviewing the overall presentation of payroll transactions and balances.

QUESTION SEVEN

External auditor responsibilities – going concern
ISA 570 *Going Concern deals with this issue.*

(i) Auditors are required to consider the going concern status of companies and any disclosures regarding going concern in forming their audit opinion. Companies that are listed on stock exchanges may be required to make additional disclosures in relation to going concern issues.

(ii) Auditors are required to assess the adequacy of the means (the processes) by which directors have satisfied themselves that the going concern basis is appropriate and that adequate disclosures have been made. Auditors conduct an initial analysis at the planning stage of the audit as well as assessments at later stages.

(iii) Auditors should make enquiries of the directors and examine appropriate documentation supporting the company's going concern status such as budgets and cash flow forecasts.

(iv) Auditors consider whether the period to which directors have paid particular attention is adequate. This should normally be at least 12 months from the balance sheet date. Auditors also enquire of management as to their knowledge of events or conditions beyond this period that may cast significant doubt on the entity's ability to continue as a going concern.

(v) Auditors need to consider the appropriateness of assumptions which directors have made, the sensitivity of assumptions to external and internal changes, any obligations, guarantees or undertakings arranged with other entities, the existence and adequacy of borrowing facilities and the directors' plans to deal with any going concern problems.

(vi) Auditors are required to document the extent of any concerns, taking account of matters that have come to their attention during the course of the audit and in particular, financial, operational, or other indicators of going concern problems that are present.

(vii) Indicators of going concern issues would include trading losses, impairment of assets, net liabilities, defaults on loans, liquidity problems, an inability to refinance loans where necessary, fundamental changes in the markets or technology having an adverse effect on the company, loss of management, staff, customers or suppliers, or major litigation, for example.

(viii) Auditors should consider the need to obtain written management representations.

(ix) Auditors should consider the adequacy of any disclosures in the financial statements.

(b) Possible audit reports and circumstances

(i) Where the auditors consider that there is a significant level of concern about the entity's ability to continue as a going concern (but do not disagree with the going concern basis), and where adequate disclosures of the situation are made, they modify (but do not qualify) their opinion by including an ‗emphasis of matter' paragraph highlighting the existence of a material uncertainty as to the going concern status of the entity and drawing attention to the relevant note in the financial statements. Where adequate disclosures are not made, a qualified or adverse opinion will be issued.

(ii) Where the period to which directors have paid particular attention is less than 12 months from the balance sheet date, the auditors should consider the need to modify the audit report as a result of a limitation in the scope of the audit.

(iii) Where the auditors disagree with the preparation of the financial statements on the going concern basis, they should issue an adverse opinion. This is very rare because auditors rarely have sufficient evidence to be sure.

(iv) If the auditors are unable to form an opinion on the going concern status of a company because of a limitation in the scope of the audit, they will issue an ‗except for' opinion, or ‗disclaimer of' opinion – but this is unusual.

(c) Report issued to Celtel

(i) In the case of Celtel, there are some indicators of going concern problems. However, the company may still be a going concern and the fact that the company has been approached by take-over bidders does not necessarily mean that there is a going concern problem (possibly quite the opposite).

(ii) The audit opinion issued on Celtel in the current year is not likely to make reference to the going concern status of the company, as in previous years. The situation has not deteriorated significantly in the current year and it will be difficult for auditors to justify any change in their opinion from previous years.

(d) Difficulties associated with reporting on going concern

(i) If the auditors of Celtel were to report on a going concern problem, the mere act of reporting might of itself create a going concern problem (a ‗self-fulfilling prophecy'). This is particularly the case with large ‗blue-chip' companies where the issue of an audit report that is modified in any way is unusual and might well cause the company's share price to drop, thus precipitating a going concern problem.

(ii) This means that it is very difficult for companies such as Celtel and their auditors to send out any clear signal to the markets without running the risk of creating a panic.

(iii) However, recent events show that the consequences of companies and auditors failing to report where severe financial difficulties are encountered can be disastrous for both the company (its employees and shareholders) and auditors alike.

(iv) Auditors are failing in their professional duties if they do not report on going concern problems of which they are aware; however, situations involving large companies are rarely clear cut and auditors who propose to make any changes at all to the audit report are likely to encounter fierce resistance from management who may genuinely believe that to make such a report would be wrong.

(v) In the company's annual financial statements, it is not the place of the auditor of Celtel to substitute his judgement for that of directors. However, where large companies involved in complex financing arrangements are concerned, auditors may have to fight hard against vested and powerful interests if they disagree with the directors' judgements and decide to make reference to the matter in the auditor's report. An auditor making reference to going concern issues in an audit report in such circumstances may lose the audit (and any other work) and may run a significant risk of litigation.

QUESTION EIGHT

(a) (i) Objectives and how they are met: overall review of financial statements

1. The objective of a review of financial statements is to provide the auditor with sufficient audit evidence, when taken together with the conclusions drawn from the other audit work, to form an opinion on the financial statements. This includes determining whether the information in the financial statements is properly presented and disclosed in accordance with accounting standards, legislation and other regulatory requirements. The usual means of achieving this is by the completion of a disclosure checklist.
2. Auditors should consider the appropriateness of accounting policies in particular and whether they have been consistently applied, particularly where changes have been made. There is no indication that any such changes have been made.

3. Auditors should also consider whether the financial statements as a whole are consistent with the auditor‘s knowledge of the business. This involves consideration of the aggregate effect of uncorrected misstatements, any overall bias in presentation and will normally involve analytical procedures on the final financial statements. This exercise involves the application of professional judgement and, in the case of Sunrise, it is likely to be carried out by the senior manager and/or the audit engagement partner with the assistance of the audit manager.

(ii) Objectives and how they are met: review of working papers

1. The objective of a review of working papers is to ensure that all work has been properly planned, executed and recorded and that all outstanding matters have been followed up.
2. In the case of Sunrise, it is likely that some work will have already been reviewed. It is common for audit seniors and audit managers to review the work of audit juniors, and for senior managers and partners to review the work of managers and seniors. There will also be a final partner review of the file.
3. Where working papers are prepared manually, staff normally evidence review of working papers by initialling the working paper. Review comments are often written in red and referred to the person preparing the working paper or to the partner where significant matters of judgement are concerned. Where papers are prepared electronically, electronic ‗signatures‘ can be used.
4. It is important that a detailed review of working papers takes place in areas that are critical to the audit. In this case, critical areas are likely to include inventory (despite the fact that it is well-controlled, it is still a material item), cash and non-current assets.
5. It is also important during the final stages of the audit of Sunrise that all outstanding areas (i.e. the substantive areas) are completed, reviewed and any issues arising followed up. It is very easy for apparently insignificant matters to ‗slip through the net‘ at this stage where both auditors and client are under pressure.

(b) (i) Responsibilities

ISA 560 *Subsequent Events* deals with this issue.

1. Auditors should perform procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of the audit report which require adjustment or disclosure in the financial statements have been properly made.

2. If matters requiring adjustment or disclosure are discovered after the date of the audit report but before the financial statements are issued, or even after they have been presented, auditors should ascertain whether and how any necessary changes are to be made to the financial statements.

3. The decision as to whether financial statements should be changed is that of the directors. Auditors cannot ‗change their minds‘ once the audit report has been signed but if new

financial statements are issued they can issue a new audit report which should make reference to the previous financial statements and audit report.

4. If auditors consider that the financial statements contain material errors or are misleading, they may exercise an right to speak at general meetings and to make written representations to members.

5. If matters are discovered long after the financial statements have been issued, it is common to deal with the matter as a prior period adjustment in the subsequent financial statements. 14

(ii) Subsequent events review procedures

1. These include making enquiries of management as to how they have ensured that subsequent events have been identified, although it is likely that in this case the company will rely on the audit firm to help them with this.
2. Auditors will read the minutes of management, shareholders and other meetings and review relevant accounting records. In this case, they are likely to review any budgets or cash flow forecasts. It is likely that these will have been prepared as a result of the negotiations with the bank.

3. In the case of Sunrise, the auditors are likely to enquire as to the possibility of any new share or loan issue to fund the expansion which may require disclosure. They may also enquire as to any significant changes in the property market that might (if the supermarket properties are carried at valuation) require either disclosure or adjustment in the accounts.

4. Auditors will also consider the need for disclosure of significant leasing transactions occurring early in the following year.

MOCK FOUR

QUESTION ONE

a) Errors and misappropriations – cash

(i) Receipts

- Money paid into the bank may be stolen. If cash is not properly controlled it is possible to falsify documentation in relation to receivables, and to pay company receipts into private bank accounts. This is sometimes known as _teeming and lading‘.
- Money paid into the bank may be incorrectly accounted for, either by the bank or by the company, if there are no controls to check the accuracy of the company‘s records or the bank statements. This could mean that the internal records and the financial statements are incorrect.

(ii) Payments

- Money paid out of the bank may be paid to incorrect suppliers, or may be paid for incorrect amounts resulting in operational difficulties with cash and supplier management;
- Money paid out of bank accounts may also be misappropriated by payments for goods and services that are not received, or simply by payments into private bank accounts if there are no controls to prevent this.

(iii) Interest and charges

Banks make errors in calculating interest and charges. If the company does not check these, it may lose money and the amounts appearing in the financial statements may be incorrect. This is particularly important for companies that hold high levels of cash.

(b) Principal audit objectives of cash audit and related audit evidence

<u>Audit objectives are dealt with in ISA 500 _Audit Evidence‘</u>

(i) **Existence**: to ensure that the cash actually exists at a given date. The related evidencewill include cash counts. Cash counts need not necessarily be conducted at each location (unless the amounts are material), the firm might consider conducting counts on a rotational basis, year on year. The decision as to which sites to visit might be determined on the basis of materiality and analytical procedures. Cash balances should be reconciled to records held at the shop and records held at head office. Any shortfalls in cash, or _IOUs‘ should be thoroughly investigated.

(ii) **Completeness:** to ensure that there is no unrecorded cash. This means reconciling cashbalances to records held at the shop and records held at head office, as above, ensuring that proper sales cut-off has been achieved.

(iii) **Rights and obligations**: to ensure that the company has a right to the cash. Thismeans checking to ensure that credit card vouchers are correctly made payable to the company, and not to third parties.

(iv) **Occurrence:** to ensure that the cash belongs to the company at the year-end date. Thismeans checking to ensure that no credit card vouchers are post-dated.

(vi) Measurement: to ensure that amounts are correctly recorded in the proper period. Thismeans ensuring that cut-off is correct and consistent between the records held at shops, the returns to head office, and the records held at head office.

(vii) Presentation and disclosure: to ensure that the cash balance and related incomestatement entries are correctly disclosed in the financial statements in accordance with legislation and accounting standards.

(c) Why auditors seek bank confirmations – matters confirmed

This matter is noted in ISA 505 _External Confirmations‗.

Auditors seek bank confirmations in order to provide third party, written evidence in relation to the balance sheet disclosure of cash, liabilities and related items.

The matters typically confirmed by the bank include:

(i) Details of all bank balances, overdrafts and loans held at all branches.
(ii) The charges or restrictions over any such accounts.
(iii) The terms and repayment conditions of loans and overdrafts.
(iv) Any right of set-off between accounts in credit and other balances.
(v) Any securities held by the bank (such as fixed assets charged as security).
(vi) Any relationships with other banks the bank is aware of.

QUESTION TWO

LETTER OF REPRESENTATION

- Auditors seek a letter of representation in order to obtain written audit evidence on matters that are material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist (ISA 580 _Management Representations‗).
- Representations may be the only evidence, which can reasonably be expected to be available, but they cannot be a substitute for other audit evidence that could reasonably be expected to be available. Such matters may include management‗s intention to hold an item for long-term appreciation.
- The letter also ensures that directors acknowledge their collective responsibility for the presentation and approval of the financial statements. The letter is signed by those with knowledge of the matters concerned, on behalf of management.

(b) Common categories of matters included in the letter of representation

- Confirmation of responsibility for, and approval of, the financial statements.
- Confirmation that all of the accounting records, and all related documentation (such as minutes of management and shareholder meetings) have been made available, and that company transactions have been properly reflected therein.
- Confirmation of the expected outcome of legal claims.
- Confirmation of company plans in relation to certain tax provisions.
- Confirmation of the completeness of disclosure of related party transactions.
- Confirmation that there have been no post-balance sheet events that require revisions to the financial statements.

(c) Discussion of the content of the letter

- It is important to discuss the contents of the letter at an early stage because directors may disagree with what the auditors wish them to sign.

- It is important in such cases for negotiations to take place and the letter to be redrafted until it is acceptable to both auditor and client.
- The management representation letter is often regarded as a critical piece of audit evidence and if it is left to a late stage in the audit, when there is pressure on auditors and clients alike, negotiations may be difficult.

(d) Management unwilling to sign and actions if management refuses to sign

- Management is sometimes unwilling to sign because they feel that auditors should be able to obtain independent evidence in relation to the relevant matters. Alternatively, they may feel that the auditors are trying to shift responsibility for the audit to them;
- Sometimes, management is genuinely uncertain about whether it is sure of the matters included. However, there are occasions on which management is trying to _hide' from the auditors the fact that the income recorded is incomplete, or the fact that there is an outstanding undisclosed legal claim against the company, for example;
- Auditors should attempt to negotiate an agreement, as noted above. A formal letter may not be necessary, if management is able to provide some other written confirmation, such as a note of a meeting. Alternatively, a list of issues may be taken to the client to establish exactly which representations are causing the problem, and the letter redrafted;
- If management still refuses to sign, and the auditor feels that the matter is critical to the financial statements, it may be necessary to qualify the audit report with an _except for' (or even disclaimer of) opinion, on the basis of a limitation in the scope of the audit.

QUESTION THREE

a) Responsibilities of external auditors to directors and shareholders

- The external auditors are required to prepare a report to shareholders on the truth and fairness (or fair presentation) of financial statements prepared by management for the benefit of shareholders.
- The auditors, if appointed by shareholders, act as agents for the shareholders in the same way as directors act as agents for the company.
- Auditors have no specific duties to directors although it is clearly necessary that an adequate working relationship is formed in order that the audit can be performed properly. Directors generally have a duty to provide auditors with the information and explanations they require to perform the audit.
- Auditing standards require that auditors report weaknesses in systems that they discover during the course of their audit to management (ISA 400 _Risk Assessments and Internal Control').

(b) Limitations of the external audit – fraud

- Auditing standards require that auditors plan and perform their audits with a reasonable expectation of detecting fraud and error if they are material to the financial statements (ISA 240 _Fraud and Error').
- It is commonly believed that the purpose of the external audit is to detect, and report, fraud and error. The detection and reporting of such matters is secondary to forming an opinion on the financial statements.
- Material fraud is often very difficult to detect, however, and an auditor has not necessarily failed in his duty if he fails to detect such a fraud.
- Most frauds are small, and immaterial to the financial statements. If auditors detect frauds, they have a duty to report such matters to the management of the company

regardless of whether they are material or immaterial. Only matters that are material need to be reported in the financial statements.

(c) External auditor independence

- External auditors are unable to fulfill their duties to shareholders if they are not independent of the entity on which they are reporting.
- If external auditors have an interest in the financial statements on which they are reporting, they may not be objective. For example, if, in the case of a listed company, they have prepared the financial statements on which they are reporting, their view may not be considered objective.
- If they have financial or employment connections with the company on which they are reporting they will not be objective.
- If they provide a significant level of additional services to the entity, it is argued that they cannot report objectively as auditors to shareholders.

(d) Advantages and disadvantages of external auditors providing consulting services

- The principal advantage of providing consulting services lies in the fact that auditors are best placed to provide such services, because they have an intimate knowledge of the operations of the company.
- Equally, if they provide consulting services, the knowledge so obtained will be useful in conducting the audit, and experience in general of consulting better enables auditors to conduct their duties as auditors, because knowledge of other industries can be brought to bear on the client.
- The principal disadvantage is that auditors often make a lot of money from such work, and it is argued that auditors are not objective in these circumstances because they would be unwilling to challenge directors or issue a qualified audit report for fear of losing the fees for consulting work.
- The other disadvantage is that if they have implemented systems that produce the financial statements, they are unlikely to give a qualified audit report on the information that those systems produce.

QUESTION FOUR

a) The indications or risk that continuance as a going concern may be questionable could come from financial statements or from other sources

Financial indicators

- Liabilities are more than the assets of the company;
- Borrowings with fixed repayment dates approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term projects undertaken by the company.
- Adverse key financial ratios e.g. current ratio below one;
- Substantial operating losses.
- Inability to pay creditors on due dates.
- Difficulty in complying with terms of loan agreements e.g. failure to pay interest and principal on due dates.
- Change from credit to cash on delivery transactions with suppliers.

Operating Indicators

- Loss of key management without replacement.
- Loss of major market or customer.
- Labour difficulties or shortage.

Other Indicators

- Non-compliance with capital or other statutory requirements. This could lead to the company being wound up under the law.
- Pending legal cases against the entity that may, if successful result in judgments that could not be met.
- Changes in legislation or government policy that adversely affects the client‘s business.

b) Where there is adequate disclosure in the financial statements

I) According to ISA 700 the auditors report on financial statements, the going concern problem is a fundamental uncertainty i.e. it is uncertain whether the company will continue to trade to 31 December 2004, and if the company failed, the consequences of the failure would have a fundamental effect on the financial statements. Since the financial statements have given adequate disclosures about the uncertainty created by the going concern problem the auditor should issue an unqualified opinion with an emphasis of matters paragraph. The emphasis of matters paragraph will disclose the going concern problems and refer to the relevant notes in the financial statements. Normally, the paragraph will say that the continuation of the business will depend on the company becoming profitable and the bank and creditors continuing support to ACB Computers Limited.

II) If there is no disclosure of the going concern problem in the financial statements then the financial statements are misleading since the effect of the disagreement is so material and pervasive. The auditor should issue an adverse opinion. The opinion paragraph should give details that have led to the qualification i.e. the need for the company to become profitable and obtain support from the creditors and the bank and also because of the failure to include details of the going concern problems, the financial statements do not show a true and fair view of the company‘s affairs as at 31 December 2003 and of its loss for the year then ended.

c) Since ACB Computers Limited has failed within a year and the auditor had given an unqualified report, certain parties may be able to successfully sue him for negligence. The decision in the Caparo case is that only the company and the shareholders as a body can bring a claim for negligence against the auditor. It is possible that the court will refer to the ISA that indicates that the audit report should have mentioned the going concern problems. As the auditor did not mention them, the claim for negligence could be successful. In the situation, the going concern problems were apparent during the audit and this reduces the strength of the auditor‘s defense. There are a variety of arguments the auditor could make in defense against a negligence claim, but these depend on the circumstances. If ACB failure was caused by a sudden event or one that occurred after the audit report was signed and was not expected to occur at the time the audit report was signed, then the auditor may have a good defense against the negligence claim. These could include a legal claim against ACB, a substantial loss on a contract entered into after 31 December 2003. If the failure was not foreseen as at 31 December 2003 then the auditor can avoid a claim for damages.

QUESTION FIVE

a) The work I will perform in checking supplier‘s statements to the balances on the purchase ledger will include:

- I will assess the system of control in the purchases system and its credibility. This will be based on the results of my tests of control, other investigations an my experience in previous years. Where the purchases system is reliable, I will check fewer items than if it is unreliable. If I find discrepancies in my audit tests, I will increase the sample of items I check. I will check fewer suppliers' statements to the purchase ledger balances if the company perform these checks and corrects discrepancies;

- Generally I will check a larger proportion of suppliers where the balances are large, or where there are a large number of transactions. Where there is no supplier's statements for one of these important accounts, I will either contact the supplier to confirm the balance, or ask for a statement at the year end;
- Where the balance on the supplier's statement is the same as the purchase ledger balance, I will record this in my working papers and carry out no further work;
- Where there are differences, these could have resulted from either goods in transit, cash in transit or other differences;
- Goods in transit are invoices on the supplier's statement, which are not on the client's purchases ledger. If these invoices have been included in the accruals, I may perform no further audit tests. However, for large value items, I will check the goods received note (GRN) to ensure they were received before the year-end. If there is no purchase accrual, I will check the date on the GRN. If the date on the GRN is after the year-end, the treatment is correct. However, if it is before the year end there is a cut off error, and management should be advised to include the value of these goods in the current years closing stock and accrual the amount payable;
- For cash in transit, I could check to the next month's supplier's statement that the cheque was on the supplier's sales ledger just before the year-end. An alternative procedure is to check to the bank statement the date the cheque is cleared by the bank after the year-end. If there is a significant delay in clearing the cheque, this could indicate that the cheque might have been sent to the supplier after year- end. If this has been happening, the value of these cheques should be added to the year end bank balance and added to creditors at the year end since the payment was made after the year end;
- For other differences, if they are small they can be ignored. However, if they are significant I will discuss them with the client. The year end accounts should include appropriate provision to allow for such differences;
    - Based on these tests, I will assess whether they provide sufficient evidence that the trade creditors and purchase accruals are correctly stated at the year-end.

b) The best place to start purchases cut-off test is from goods received notes issued immediately before and after the year- end. Generally, the test should cover a sample of items during the period of two weeks before to two weeks after the year -end.

At the stock take, I should have recorded the last goods received note number issued before the year-end. This will assist in confirming that all items purchased before the year-end are included in the stock and the liability disclosed. I will select a sample of goods received notes issued before the year- end, and follow through to the purchase invoice. For these goods I will check that:

- Either the purchase invoice has been posted to the purchase ledger before the year end or a purchase accrual has been made;
- If there are book stock records, I will check that the goods have been included in the records before the year -end.

There will be a purchases cut off error where either:

- The purchase invoice has not been posted to the purchase ledger before the year end and there is no purchase accrual; or

- The purchase invoice has been posted to the purchase ledger before the year end and there is a purchase accrual at the year end.

For goods received after the year- end, I will select a sample of goods received notes issued after the year-end, and follow through to the purchase invoice. For these goods I will check that:

- Neither the purchase invoice has been posted to the purchase ledger before the year end nor a purchase accrual been made;
- If there are perpetual stock records, I will check that the items received have not been included in the stock records before the year- end.

There will be cut off error where either:

- The purchase invoice has been posted to the purchase ledger before the year end,; or;
- There is a purchase accrual made.

c) I will perform the following work in checking sundry creditors and accruals

- I will assess the level of accruals and the system of control. If the company‘s system of determining accruals is good, I will perform less work than if the controls are weak;
- I will compare this year‘s accruals with the previous year. I will investigate any significant variances e.g. where there was an accrual in the previous year but none this year;
- The wages accrual will be checked to the payroll, the accrual should be equivalent to one weeks gross wages;
- The PAYE should be checked back to the payroll. The accrual should equal the December PAYE payable. I will check to the cash book that the accrual is equal to the payment made to the government in January 2004;
- The VAT creditor will be checked as being the net of out put VAT (VAT on sales) and Input VAT (VAT on purchases). This should be checked against the VAT paid over to the government in January 2004;
- Accrued interest on the bank loan and overdraft will be checked to be bank confirmation received. For loans, the accrued interest should be the product of the amount outstanding, the current interest rate and the time since the last charge;
- Other accruals will be checked to invoices received after the year end;
- I will consider whether there are any circumstances which have arisen during the year which may result in new accruals and I will check if these have been made.

QUESTION SIX

a) You are required to briefly explain the meaning of the term "control procedures".

Control procedures are the detailed policies and procedures established by management within the control environment. Control procedures put together constitute an internal control system. For example the requirement that all purchase orders must be authorised by a senior responsible company official is an example of a control procedure. Control procedures are aimed at achieving a desired control objective. For example the above requirement that purchase orders should be authorised is an example of a preventive control aimed at ensuring that all purchase transactions have received the necessary approval which will assist in the prevention of errors and frauds.

b) You are required to discuss the importance of segregation of duties as a control procedure.

Segregation of duties refers to the separation of the various duties and responsibilities such that one person cannot process and record complete transactions from beginning

to the end without being checked by another person. E.g. in the purchase of a company's fixed assets a single individual should not authorise the purchase, place the order, receive the asset and record the transaction in the accounting records, to minimise the risk of error and/or intentional manipulation of information.
Segregation of duties is important because:

- It helps detect errors in processing transactions. This is because the work of one individual will be checked by another. Errors made will be detected;
- Helps in deterring fraud. Segregation of duties would help in deterring people from perpetrating frauds. This is because the work of every individual is counter checked by another person.

c) You are required to List and briefly explain the substantive tests the auditor would carry out to verify the values attributed to:

i) Trade debtors in a company's financial statements.

Substantive tests are the tests that the auditor carries out to obtain evidence as to the completeness and validity of the balances reported in the financial statements i.e. procedures carried out to test the management assertions.

In regard to debtors the following substantive procedures will be necessary:

- To carry out a trend analysis on the level of debtors by comparing the current year debtors with the previous two years and obtaining explanations for the reported trend. The evidence obtained from this analysis will assist the auditor in identifying circumstances that could lead to the misstatement of debtors balances;
- Compute the debtors' days, debtors' turnover and the ratio of provisions for doubtful debts to trade debtors' balances. Compare the ratios with the previous year and obtain explanations for any significant variations. Such an analysis will assist the auditor in evaluating the recoverability of the debtors' balances and whether an adequate provision has been made;
- Obtain a listing of balances as at the year end and agree the total to ledger balance;
- Select a sample of debtors' balances and perform circularization. This will assist in confirming existence of the balances;
- Obtain a sample of significant balances and verify if any payments have been received after the year-end. This will provide good evidence as to the recoverability of debtors balances;
- Discuss with management accounts that appear doubtful. This will include accounts above the authorised credit limits, accounts with disputed balances and balances that have been outstanding for a long period of time. Ensure that an adequate provision has been made for these balances;
- Test the operation of the cut-off procedures by obtaining details of the last dispatch note processed during the year and ensure that all transactions that relate to the current financial period have been recorded.

(ii) Trade creditors in a company's financial statements.

a) Compare the current years creditors balance with the previous year and obtain explanations for any significant movements. Such an analysis will give indications for example on the completeness on creditors.
b) Compute the creditors days and compare with the previous years and obtain explanations for any significant movements. Creditors days give an indication of the number of days it takes on average to pay creditors.

c) Obtain a creditors listing and verify that the total per the listing agrees with the total per the ledger.

d) From the listing select a sample of creditors and carry out the following procedures:

- Obtain or prepare a reconciliation of the creditors balance per the ledger to the suppliers' statements;
- Obtain explanations for all the reconciling items and where appropriate ensure that the reconciling items have been adjusted in the books of account. The reconciling items will mainly include suppliers invoices not posted in the clients ledger or payments not reflected in the suppliers statements.

e) Obtain a sample of payments made to suppliers after year- end and verify that all the invoices that related to the period under review had been accrued for.

f) Obtain all the pending invoices that relate to the financial period under review and verify that these had been accrued for.

QUESTION SEVEN

a) Application controls

These are control procedures over the accounting system designed to provide reasonable assurance that all transactions are authorised, recorded and processed completely, accurately on timely basis. Application controls may be manual or programmed and are include

- Controls over input
- Controls over processing
- Controls over output
- Controls over master files and standing data.

General controls

These are controls which relate to the environment within which computer based accounting systems are developed, maintained and operated aimed at providing reasonable assurance that the overall objectives of internal controls are achieved. These controls could either be manual or programmed.
General controls include

- Controls over systems development and maintenance
- Controls over data files
- Computer operations controls
- Controls to ensure continuity operation.

b) Importance of system documentation.

i. Provides a basis for management to review the system prior to authorisation
ii. Staff training on the use of system.
iii. Implements smooth personnel changes and avoiding the problem that key employees may take with them all knowledge about the way the system works.
iv. Revising existing systems and programs
v. It is useful to the auditor for preliminary evaluation of the system and of its controls.
vi. Could assist in disaster recovery.

c) How and why both systems should run parallel prior to the change over to the new system.

How

The client should continue to process the information using the old system while at the same time implement the new system. The output from the new system should be compared with the output from the new system.

Why

i. Parallel running assists in staff training. The users learn about the features of the new system and compare this with the old system
ii. Assists in testing the new system.

Allows for the systems developers to make any necessary changes to the new system before being fully implemented.

QUESTION EIGHT

a) Matters to consider when planning the audit

In planning the audit the auditor will need to consider the following:

1. Understanding the accounting and internal control systems
   The auditor‘s cumulative knowledge of the accounting and in ternal control systems and the relative emphasis expected to be placed on tests of control and substantive procedures.
2. Reviewing matters raised in the previous year‘s audit, which may have continuing relevance in the current year. This is done by reviewing previous year‘s working papers. The auditor will be able to identify areas noted as having weak controls or specific accounting problems. Attention should be paid to such areas in the audit plan.
3. Assessing the effects of any changes in legislation or accounting practice affecting the financial statements of the company. The audit plan should include a review of these changes and whether the client has complied.
4. The auditor should consult with management and staff of the organization about current trading circumstances and any significant changes in the business carried on and the management of the enterprise. E.g. changes in management might weaken the internal control system.
5. Identify any significant changes in the clients accounting procedures such as installation of a new computer information system. Changes to a computerized system could result in weak controls.
6. Conditions requiring special attention such as the existence of related parties.
7. Consider any current or impending financial difficulties, which could face the company. E.g. shortage of raw materials or failure to raise working capital.
8. The auditor should check the nature and timing of reports and other communications with the client so that the audit plan accommodates such timings e.g. he should consider the dates of the annual general meeting, stock taking, dates when management reports are available.
9. Set materiality levels for audit purposes and in particular identify areas with material transactions, which call for more audit work.
10. The assessment of internal audit department and level of reliance to be place on its work. The auditor should also determine the number of audit staff required, experience and special skills required and the timing of the audit visits.

b) Ways to control the audit

1. Scoping of the work and delegation

First I would determine the scope of the work to be carried out and our client‘s expectation. Basing on this I will identify the staff that I will require to carry out the work. In doing this I will need to consider, the complexity of the assignment and the level of experience required of the staff. I will delegate the work to a team that has appropriate training and experience to carry out the work

2. Direction

I would give appropriate instructions/directions to the staff I have delegated the work to. This involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. This also involves informing them of matters such as the nature of the entity‘s business and possible accounting and auditing problems that may affect the nature, timing and extent of audit procedures to be performed. I would summarise such instructions in an audit programme.

3. Supervision of the work

I would supervise the work being carried out by the audit team. This will include:

- Monitoring the progress of the audit to consider whether assistants have the necessary skills and competence to carry out their assigned tasks;
- Establish whether assistants understand the audit instructions as documented in the audit programme;
- Ensure that work is being carried out in accordance with the overall audit plan and the audit program;
- To identify and address any significant accounting and auditing questions raised during the audit;
- Resolve any differences of professional judgment between the audit team.

4. Review

Before submitting the work to the partner I will need to review the work done. This is to ensure that:

- The work has been performed in accordance with the audit program
- The work performed and the results obtained have been adequately documented.
- All significant audit matters have been resolved or are reflected in audit conclusions.
- The objectives of the audit procedures have been achieved; and
- The conclusions expressed are consistent with the results of the work performed and support the audit opinion.
- I would then submit the work done to the audit partner for review.