

NATIONAL OPEN UNIVERSITY OF NIGERIA

FACULTY OF MANAGEMENT SCIENCES

AUDITING 1 ACC210 Course Guide

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INTRODUCTION

You are holding in your hand the course guide for ACC210 (AUDITING I). The purpose of the course guide is to relate to you the basic structure of the course material you are expected to study as a student studying ACC210 in National Open University of Nigeria. Like the name ‘course guide’ implies, it is to guide you on what to expect from the course material at the end of studying the course material.

COURSE CONTENT

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

COURSE AIM

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

COURSE OBJECTIVES

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

1. Understand the concept of auditing
2. List and explain the advantages and importance of auditing
3. Explain the types of audit
4. Give reasons why audit is regulated and explain the sources of regulation.
5. Discuss the Provisions of the Companies and Allied matters Act, 2004 regarding the appointment/re-appointment, qualification, duties and powers, remuneration, removal and report of the independent auditor.
6. Explain the elements of an assurance engagements
7. State and explain the objectives of an assurance engagement
8. Explain the concept “audit programme” and its usefulness in the audit process.
9. Discuss the different types of audit programmes and state the advantages and disadvantages.
10. Discuss the types of audit testing and their importance in the audit process.

COURSE MATERIAL

The course material package is composed of:

The Course Guide

The study units

Self-Assessment Exercises

Tutor-Marked Assignment

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THE STUDY UNITS

The study units are as listed below:

Unit 1: Introduction to Auditing

Unit 2: Regulation of Audit and Assurance Services/Assurance Engagements

Unit 3: Audit Planning and Strategy

Unit 4: Professional Ethics

Unit5: Corporate Governance

Unit 6: Internal Control

Unit 7: Audit Programmes and Audit Testing

Unit 8 Internal Audit and Outsourcing

Unit 9: Verification of Assets and Liabilities

Unit 10: Audit Report

ASSIGNMENTS

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

TUTOR-MARKED ASSIGNMENT

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

SUMMARY

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

AUDITING 1
ACC210
Main Content

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UNIT 1: INTRODUCTION TO AUDITING

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1.0 INTRODUCTION

This unit introduces us to auditing, describes the importance of an audit, types of an audit, and the advantages of having an audit of financial statements.

2.0 OBJECTIVE

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

1. Understand the concept of auditing
2. List and explain the advantages and importance of auditing
3. Explain the types of audit

3.0 Main Content

3.1 Evolution of Auditing

Evidence of auditing existed during Babylonian times, around 3000 BC. Auditing activities was also found in ancient China, Greece and Rome. In Rome, auditors heard taxpayers such as farmers give public accounts of the results of their businesses and the taxes due. Thus, the word 'audit' came from the latin word 'audire', meaning to hear. The Auditor was a hearer or listener. In China and Egypt, auditors were supervisors of the accounts of Chinese Emperor and the Egyptian Pharaoh. The government accounting system of the Zhao dynasty in China included an elaborate budgetary process and audits of all government departments. The Egyptian dynasty (from about 3000 BC) made extensive use of scribes (accountants) who were held in very high esteem. Over the centuries, the role of auditors as hearers and verifiers of reports evolved to include that of verifying written records. The discovery and documentation of double entry bookkeeping in Italy by a Catholic priest, Luca Pacioli in his Summa de Arithmetica dated 20 November 1494 gave more impetus to auditing as he recommended the verification of accounting records by auditors.

The emergence of modern corporations following the industrial revolution saw the emergence of modern auditing. Britain passed the Joint Stock Companies Act in 1844 which among other provisions, required company directors to report to shareholders through audited financial statements. The Society of Accountants was founded in Edinburgh in 1853. In 1880 several other societies of Accountants that were formed within this period merged into the Institute of Chartered Accountants in England and Wales. The 1862 English Companies Act, contained provisions that required the use of trained and specialized professionals to conduct an independent review of company financial statements and the preparation of the corrected accounts and financial statements. As many Joint stock Companies were formed and ownership became increasingly divorced from management, there arose the greater need for an independent party – the auditor – to lend credibility to the information provided by the agent – managers. This is probably the reason why the English Companies Act, 1900, legally made it compulsory for every company to appoint independent auditors as we know them today.

Since then, auditing has evolved from its primary objective of preventing and detecting fraud to its current state of attesting to the fair representation of audited financial statements through a very highly enhanced auditing procedures and techniques.

3.2 Auditing Defined

Auditing is defined by the American Accounting Association (AAA) as a systematic process of

objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the result to intended users. This definition is widely accepted as it describes what auditing entails as well as what the auditor does. Auditing is a planned, logical and scientific activity (systematic process); it involves the auditor gathering and evaluating evidence on the representations made by management (assertions) with regard to elements of financial statements (economic actions and events). The auditor compares the evidences he has gathered and evaluated and the accepted accounting practices to know if they are in agreement to enable him express an opinion. The auditor then communicates the outcome of his examination, evidence gathering and evaluation and comparison to users through his audit report.

R.K Moutz, defined auditing as an examination of the accounting books and the relative documentary evidence so that an auditor may be able to find out the accuracy of figures and may be able to make report on the balance sheet and other financial statements which have been prepared from there.

We can therefore extract the facts listed below in connection to audit:

- Checking of books of accounts and documents of evident on the basis of generally accepted principles and procedures.
- Checking the books of accounts whether the results presented by the profit or loss account and financial position presented by balance sheet are true and fair or not.
- Checking works performed by the staff whether they have been performed within lines of authority or not.
- Preparation of report based on the fact found during the course of audit.
- Checking the books of accounts to determine whether the financial statements and profit or loss statement are prepared in conformity with relevant accounting standards such as International Financial Reporting Standards (IFRSs).

3.3 Objectives of Audit

This is divided into primary and secondary objectives.

A. Primary Objective: The primary objective of an audit of financial statements is to enable the auditor express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Thus, the primary objective of an audit is the expression of professional opinion as to whether or not, the financial statements examined by the auditor, for a reporting period, give a true and fair view (that is, fairly presented in all material respects).

This primary objective is achieved through, among other activities:

- Proving true and fairness of operating results presented by statement of profit or loss and statement of financial position of the organization.
- Examining the system of internal control
- Checking arithmetical accuracy of books of accounts, verifying posting, costing, balancing etc.
- Verifying the authenticity and validity of transactions.
- Checking the proper distinction of capital and revenue nature expenses (proper classification of transactions and events).
- Confirming the existence, ownership and value of assets and ensuring each treatment represents what the relevant accounting standard has stipulated.
- Verifying whether all statutory requirements are being adhered to as well as compliance with all regulatory frameworks.

B. Secondary Objective

Other objectives achieved in the course of the audit process include:

- i. Detection and Prevention of frauds
- ii. Detection and prevention of errors
- iii. Evaluation of the effectiveness and appropriateness of internal control system over financial reporting and submitting a report to management for needed improvements
- iv. Evaluating and reporting on the likelihood of the business continuing as a going concern

and

- v. Providing valuable advice to the entity audited on areas such as accounting systems, taxation matters, risk management practices and other incidental matters.

Self- assessment questions

1. What is an audit?
2. State the objectives of an audit.

3.4 Advantages of an audit

1. Deterrent to Inefficiency and Fraud

When employees know that an independent audit is to be made, they take care to make fewer errors in performing the accounting function and are less likely to misappropriate company assets

2. Audit Helps To Maintain Account Regularly

An auditor raises questions if accounts are not maintained properly. So, audit gives moral pressure on maintaining accounts regularly.

3. Audit Helps To Get Compensation

If there is any loss in the property of business, insurance company provides compensation on the basis of audited statement of valuation made by the auditor. So, it helps to get compensation.

4. Audit Helps To Obtain Loan

Financial institutions most times, provide loan to organisations on the basis of audited statements. A lending banker may require for assessment 3 to 5 years' audited financial statements of an organization as a basis for granting loans to the entity.

5. Audit Facilitates the Sale of Business

Audited financial statements provide basis for the valuation of businesses for the purpose of mergers and acquisitions. It helps to determine the price of businesses.

6. Audit Helps To Assess Tax

Tax authorities assess taxes on the basis of profit reported on audited financial statements.

7. Audit Helps To Increase Goodwill

Auditing provides legitimacy of an organization's activities and thus builds faith of the public on the business. Thus, auditing helps to increase goodwill of an organization.

8. Access to Capital Market

Public limited companies must satisfy audit requirements under the Securities and Exchange Commission in order to register securities and have such traded in the securities markets. Without audits, companies would be denied access to these capital markets.

9. Lower Cost of Capital

Because of the reduced information risk associated with audited financial statements, creditors may offer lower interest rates, and investors may be willing to accept a lower rate of return on their investment.

10. Control and Operational Improvements

The independent auditor can often make suggestions to improve controls and achieve greater operating efficiencies within the client's organization.

3.5 Limitations/Disadvantages of Auditing

The primary objective of an audit is to express a professional opinion on the 'Truth and Fairness' of financial statements examined by the auditor. Giving this opinion involves judgments and materiality levels set by the auditor while designing his procedures and tests.

Based on the above, the following limitations of auditing could be noted:

1. Testing is used – the auditors do not oversee the process of building the financial statements from start to finish. Not all items in the financial statements are tested. Tests are based on samples with associated sampling risks.
2. The accounting systems on which assurance providers may place a degree of reliance also have inherent limitations. Some of the line items/figures are estimates and judgements made by the management.
3. Most audit evidence is persuasive rather than conclusive.
4. The client's staff members may collude in fraud that can then be deliberately hidden from the auditor or misrepresent matters to them for the same purpose. Thus, the audited financial statements made be materially misstated.
5. Assurance provision can be subjective and professional judgments have to be made, for example, about what aspects of the subject matter are the most important, how much evidence to obtain etc.
6. Assurance providers rely on the responsible party and its staff to provide correct information, which in some cases may be impossible to verify by other means.
7. Some items in the subject matter may be estimates and are therefore uncertain. It is impossible to conclude absolutely that judgmental estimates are correct.
8. The nature of the assurance report might itself be limiting, as every judgment and conclusion the assurance provider has drawn cannot be included in it.
9. It does not take into account the productivity and the skills of the employees of the business.
10. For smaller companies, hiring a firm to carry out an audit can be costly.
11. Investment may be discouraged by a bad auditing.
12. Some non-routine transactions introduce significant risks;

13. Human errors in recording and testing exist;
14. There are possibilities of control overrides by those who exercise oversight function.
18. Audit evidence sometimes indicates what is probable and not certain in that they are based on intention, estimates and judgments.
19. The audit report has inherent limitations imposed by the standard format and layman's lack of understanding of audit jargons.

3.6 TYPES/CLASSIFICATION OF AUDITS

Audits may be classified according to the nature of work done by the auditor or according to approach to the audit.

Classification according to nature of work done by Auditor

The following types of audits exist under this category:

Statutory audits – these are audits required by law. The companies Act in Nigeria makes it mandatory that companies incorporated under that Act must be audited every year. This statute also specifies the scope of the audit which cannot be restricted by the owners of the business or by their managers.

Private audits – a private audit is not required by law; it is optional. The person who engaged the auditor will usually agree the scope of work to be done with the auditor. Examples of private audits include the audit of sole traders and partnerships.

Internal audit – these are audits carried out by employees of an organization (called internal auditors) to ensure adherence and compliance to policies and controls established by the management. It is an independent appraisal function established by the management for the purpose of evaluating the organisation's operations and improving the effectiveness of management controls and governance processes. The internal audit unit is increasingly involved in corporate risk management.

External audit – this is an audit carried out by an independent party (non-employee of the organization). It examines the operations and financial statements prepared by management and reports to owners of the organization. Examples are the statutory and private audits.

Classification according to Approach

Management Audit – an audit that enquires into the effectiveness and efficiency of management in executing the organization's policies, programs and plans. The audit examines the organizational structure, or any component of it, its plans and objectives, its means of operation and how management deploys human resources and physical facilities. Management is usually carried out by the internal audit unit or a management consultant. The benefits of a management audit include:

- Providing the board with access to constructive advice and report of their performance,
- Providing meaningful feedback for managers at all levels; and
- Discouraging unhealthy and fraudulent management practices and procedures

Transaction audit (Vouching approach) – this audit approach tries to authenticate the validity and accuracy/correctness of accounting records and the source documents used in preparing the financial statements. It is a direct method of generating audit evidence to support the transactions and events that occurred in the organization within the reporting period.

Balance Sheet (Statement of Financial Position) audit – this audit approach examines the balance sheet of the organization with the objective of verifying the assets, liabilities and equity (capital) by tracing the items back to the underlying records and source documents. The main objective of a balance sheet audit is to confirm that the financial statements presented agree with the underlying records and other books of account. The merits of Balance sheet audits lie on the fact that they help in confirming the existence, ownership and proper valuation and presentation of assets, liabilities and components of equity. Balance sheet audits also highlight the control measures over assets and liabilities.

Continuous audit – This involves carrying out continuous reviews, tests and procedures on the

operations of an entity. Internal auditors mostly adopt this approach since they are always in the work environment. Where volume of transactions is big and there is a tight reporting deadline to meet, the external auditor also adopts this approach. Continuous audit, for the external auditor, ensures a timely conclusion of the audit and helps in effective deployment of audit staff, especially during slack periods.

The disadvantages of this audit approach include:

- Increasing the chances of over-auditing;
- Interrupting the client's daily routines;
- It is generally expensive to carry out; and
- The independence of the auditor may be impaired where there is too much familiarity.

Final or completed audit – This is also known as periodic or annual audit and it is usually conducted by the financial year end after the books of account are closed. The auditor visits the client once in the year during which period the entire audit assignment is carried out.

The advantages of this audit approach include:

- Audit evidence obtained is more reliable;
- Financial statements are finalized and published on time;
- Figures cannot be altered after the audit; and
- Work is carried to conclusion in one session without recourse to return visits.

But where audit firm has many clients with common year end, there may be a challenge in getting adequate audit staff to meet the demand of clients and as a result, there may be delays in finalizing the audit.

Interim audit – an audit carried out on the interim accounts up to a particular period within the year; it does not cover a full year. The auditor wants to ascertain the accuracy, reliability and validity of the interim accounts prepared. It may be done to enable the management pay interim dividends. It assists the auditor in the timely completion of the final audit and in timely identification and correction of errors and misstatements. Interim audits impose some moral checks

on client staff.

Regulatory (Compliance) Audit

This is aimed at ensuring that expenditures have been incurred on approved services and in accordance with the enabling statutory provisions and regulations governing the particular expenditure. It seeks to determine if an organization is following specific procedures, rules or regulations set by itself or by regulatory authorities.

Procedural Audit

This is an examination and review of the internal procedures and records of an organization, in order to ascertain their reliability as a basis for compiling the final accounts. The objectives of a procedural audit usually include:

1. To assess the adequacy of the internal control system;
2. To establish whether the records are sufficiently reliable for the preparation of the final accounts;
3. To ascertain whether the procedures laid down by management are being followed.

Value for Money Audit

Value-for- money audit, also referred to as Performance or efficiency audit, seeks the maximization of the use of resources for the welfare of the public by ensuring that activities and programmes are carried out at low cost and to high standard. In addition to ensuring that financial statements faithfully represent the affairs of the establishment in relevant cases, the audit objective includes an ascertainment of whether the establishment being audited is achieving the purposes for which its programmes are authorized and whether it is doing so efficiently, effectively and economically.

Forensic audit - is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. It is applied in the

detection of different types of fraud, employee fraud, criminal investigations etc.

SELF ASSESSMENT

1. What is the difference between a continuous audit and an interim audit?
2. Define *Procedural audit*. State the objectives of a procedural audit.

4.0 Conclusion

Auditing has evolved from its earliest state when auditors sat to listen to the stewardship reports of tax payers to the industrial revolution era when the primary objective was the detection of fraud and finally to its present dynamic stage when auditing is technology - and knowledge-driven. Over this period the techniques and procedures for carrying out an audit have greatly improved and the public's need for an audit has also increased. The primary objective of an audit is currently attesting to the fair representation of audited financial statements through these very highly enhanced auditing procedures and techniques.

5.0 Summary

This unit discussed the historical development of auditing, gave some definitions and highlighted the advantages and limitations/disadvantages of carrying out an audit of financial statements. The unit also dealt with the different classifications and types of audit. The primary objective of an audit of financial statements, which is to enable the auditor express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, was underscored.

6.0 TUTOR MARKED ASSIGNMENT

1. Define Auditing and state the advantages of carrying out an audit of financial statements.
2. Briefly discuss the following types of audit:
 - a) Value for money audit

- b) Interim audit
- c) Internal audit
- d) Management audit.

7.0 References/further Reading

1. Adeniji, A.A (2012). Auditing and Assurance Services. Lagos: Value Analysis Consults.
2. ICAN (2011). Accounting technicians scheme of West Africa (ATSWA) Study pack Auditing.

ACCA (2015). Study Text on Audit and Assurance. London: BPP Learning Media.

Soyemi, K.A (2014). Auditing and Assurance Services. Abeokuta: LekSilicon Publishing Company Ltd.

UNIT 2 Regulation of Audit and Assurance Services/Assurance Engagements

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1.0 INTRODUCTION

In this unit, we discuss the regulation of audit and assurance services and the legal provisions on the appointment, work and report of the external auditor. The unit will also explain what assurance engagement is, the objectives and types of assurance engagements as well as the elements of assurance engagements.

2.0 Objectives

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

1. Give reasons why audit is regulated and explain the sources of regulation.
2. Discuss the Provisions of the Companies and Allied matters Act, 2004 regarding the appointment/re-appointment, qualification, duties and powers, remuneration, removal and report of the independent auditor.
3. Explain the elements of an assurance engagements

4. State and explain the objectives of an assurance engagement

3.0 Main Content

3.1 Need for Regulation of Audit and Assurance services.

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

3.2 Sources of Regulation:

Regulation of Audit and Assurance services is effected through:

Legal Regulation – Most countries, including Nigeria, have legal requirements associated with some assurance providers, particularly auditors. Examples of these legal requirements are found in CAMA (Companies and Allied Matters Act), 2004, ICAN Act 1965, Banks and other Financial Institutions Act 1991, Insurance Act 2003, Securities and Exchange Commission (SEC) Act 2007, EFCC Act, the Audit Act, Financial Reporting Council of Nigeria (FRCN) Act 2011 etc.

Ethical Regulation – Auditors are given ethical guidance by the professional Bodies e.g. ICAN, law and IFAC (International Federation of Accountants).

Professional Regulation – Auditors are required to carry out audits according to professional standards (International Standards on Auditing –ISAs and Nigerian Standards on Auditing- NSAs). As assurance provision goes ‘global’ the harmonization of such professional guidance has become necessary.

3.3 CAMA and the Auditor

Sections 357 – 369 of CAMA relate to the Auditor and his work.

1 Appointment of an Auditor – s.357

Every company shall at each Annual General meeting (AGM) appoint an auditor or auditors to audit its financial statements. The auditor's tenure shall run from the conclusion of the AGM where he was appointed till the next AGM.

The directors may appoint an auditor in the following circumstances:

- a. Where at an AGM, no auditors are appointed or re-appointed;
- b. The appointment of the first auditors of the company before the company is entitled to commence business;
- c. To fill any casual vacancy in the office of the auditor, but while any such vacancy continues, the surviving or continuing auditor (s) may act.
- d. A retiring auditor however appointed, shall be re-appointed without any resolution being passed unless –

He is not qualified for re-appointment;

- a. A resolution has been passed at the meeting appointing another auditor or providing expressly that he shall not be re-appointed; or
- b. He has given the company notice in writing of his unwillingness to be re-appointed.

2 Qualification of the Auditor – s. 358

A person shall not be qualified for appointment as an auditor of a company, unless he is a member of a body of Accountants in Nigeria.

The following persons however are disqualified from serving as an auditor of a company:

- a. An officer or servants of the company;

- b. A person who is a partner of or in the employment of an officer or servant of the company;
- c. A person or firm who or which offer to the company professional advice in a consultancy capacity in respect of secretarial, taxation or financial management.
- d. A body corporate.

3 Reports of the Auditor – S. 359

The auditors of a company are required to make a report to the members of the company on the accounts examined by them, and on every Balance Sheet (Statement of financial position) and statement of Profit or loss, and all group financial statements, copies of which are laid before the company in a general meeting during the auditors' tenure of office.

In the case of a public company, the auditor also makes a report to the audit committee which shall be established by the company. By the provisions of this section (s.359), the committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum of number of six members). The committee examines the independent auditor's report (including the management letter or letter of weakness) and makes recommendations thereon to the annual general meeting as it thinks fit.

The objectives and functions of the committee as specified by the Act, are to:

- a. Ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- b. Review the scope and planning of audit requirements;
- c. Review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- d. Keep under review the effectiveness of the company's system of accounting and internal control;

- e. Make recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company; and
- f. Authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

4 Duties and Powers of the Auditor – S. 360

The auditor, in preparing his report has as his duty, to carry out such investigations as may enable him form an opinion as to whether:

- a. Proper accounting records have been kept by the company and proper returns adequate for his audit have been received from branches not visited by him;
- b. The company's Balance sheet and (if not consolidated) its profit or loss account are in agreement with the accounting records and returns.
- c. If the auditor is of the opinion that proper accounting records have not been kept or that adequate returns have not been received from branches not visited by him or that the balance sheet and the profit or loss account are not in agreement with the accounting records and returns, the auditor shall state that fact in his report.

To ensure effective discharge of his duties, the Act confers the following powers on the auditor:

- a. Every auditor of a copy shall have unrestricted access at all times to the company's books, accounts and vouchers;
- b. Every auditor of a company shall be entitled to require from the company's office such information and explanations as he thinks necessary.

5 Remuneration of the Auditor – S. 361.

In the case of auditors appointed by the directors, their remuneration may be fixed by the directors; or the remuneration may be fixed by the company in a general meeting or in such

manner as the company in general meeting may determine.

6 Removal of the Auditor – S.362

A company may, by ordinary resolution, remove an auditor before the expiration of his term of office, notwithstanding anything in the agreement between the company and the auditor. A special notice of 28 days is required for this purpose. Within 14 days of passing the resolution removing an auditor, the company shall give notice of that fact to the Corporate Affairs Commission (CAC)

7 Rights of the Auditor – S. 363

A company's auditor shall be entitled to attend any general meeting of the company and to receive all notices of, and other communications relating to any general meeting which a member of the company is entitled to receive. He is also to be heard on any part of the meeting which concerns him as auditor.

In addition, an auditor who has been removed from office has the right to attend:

1. The general meeting at which the term of his office would otherwise have expired;
2. Any general meeting at which it is proposed to fill the vacancy caused by his removal;

8 Special Notice – S.364

Special notices are required for a resolution at an annual general meeting of a company to transact the following business relating to the auditor:

1. Appointing as auditor a person other than a retiring auditor;
2. Filling a casual vacancy in the office of auditor;
3. Re-appointing as auditor a retiring auditor who was appointed by the directors to fill a casual vacancy; or

4. Removing an auditor before the expiration of his term of office.

9 Resignation of the Auditor – S.365

An auditor of a company may resign his office by depositing a notice in writing to that effect at the company's registered office. Such notice of resignation by the auditor shall not be effective unless it contains either –

1. A statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company;
or
2. A statement of any such circumstances as mentioned above.

Where a notice of resignation is deposited at the company's registered office, the company shall within 14 days, send a copy of the notice to CAC.

10 Power of Auditors in respect of Subsidiary companies - S367

If the subsidiary is incorporated in Nigeria, it is the duty of the subsidiary and its auditors to give the auditor of the holding company, such information and explanations as those auditor may reasonably require.

11 Liability of Auditors for negligence - S368

A company's auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary;

Where the company suffers loss or damage due to the failure of the auditor to discharge his duties, in such manner, the auditor shall be liable for negligence and the director may institute an action for negligence against him in the court.

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

institute such an action.

12 False statement to the auditors - S369

Any officer or director of the company who gives misleading, false or deceptive information on which the auditors acted upon, shall be liable to one year imprisonment or fine of N500 or both.

3.4 Assurance Engagements

Assurance Engagements, performed by professional Accountants, are intended to enhance the credibility of information about the subject matter. The subject matter of an assurance engagement is the topic about which the assurance engagement is conducted.

As defined by the Assurance Engagement Framework, Assurance engagement means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

An audit is a specific form of assurance engagement. Other examples include:

- Report on internal controls;
- Value for money reviews;
- Environmental and CSR audits;
- Risk evaluations;
- Compliance reviews etc

3.5 Elements of Assurance Engagements

There are five elements of Assurance Engagements namely

1. A three party relationship involving *a practitioner, a responsible party and the intended users*;
2. A subject matter;
3. Suitable criteria;
4. Evidence; and
5. an assurance report.

1. Three- Party relationship – the practitioner, a responsible party and intended users.

The practitioner is the professional (e.g. auditor, accountant or an expert) who gathers evidence to provide a conclusion to the intended users about whether a subject matter (e.g. financial statement) conforms, in all material respects to identified criteria. The Practitioner, in brief, is the individual providing professional services that will review the subject matter and provide assurance.

The responsible party (e.g. the management of Board of directors) is the one responsible for the subject matter or subject matter information and chooses the criteria and may or may not engage the practitioner.

The intended users are the addressees of the assurance report and may be identified by the responsible party or by law.

2. Subject Matter - This is the data to be evaluated, that have been prepared by the responsible party.

The subject matter of an assurance engagement can take many forms, such as

- Financial performance or conditions e.g. historical or prospective financial performance;
- Non-financial performance indicators
- Physical characteristics e.g. capacity of a facility;
- Systems and processes e.g. internal controls, IT systems etc
- Behaviour (e.g. corporate governance, compliance with laws and regulations, human resource practices)

The auditor accepts an assurance engagement only if the subject matter is the responsibility of a party other than the intended user or the auditor. That is, the intended user is not management or the auditor. The subject matter must be:

- identifiable and capable of consistent evaluation or measurement against identified, suitable criteria e.g. IFRS
- in a form that can be subjected to procedures for gathering evidences to support that evaluation or measurement.

3. Suitable criteria - Are the benchmarks used to evaluate evidence or measure the subject

matter of an assurance engagement. For example, in the preparation of Financial statements, the suitable criteria may be IFRS; for internal controls, it may be established framework such as COSO or any other control objectives specifically designed for the engagement. Suitable criteria, thus are relevant to the circumstances of the engagement.

The characteristics for assessing whether criteria are suitable are:

- i. Relevance – relevant criteria contribute to conclusions that meet the objectives of the engagement and assist decision making by intended users.
 - ii. Completeness – criteria are complete when there are no omission of factors that could affect the conclusions in the context of the engagement circumstances.
 - iii. Reliability - reliable criteria result in consistent evaluation or measurement, including where relevant, presentation and disclosure of the subject matter, when used in similar circumstances by similarly qualified practitioners.
 - iv. Neutrality – neutral criteria are free from bias.
 - v. Understandability – understandable criteria are clear and comprehensive and are not subject to significantly different interpretations.
4. Evidence – Sufficient appropriate evidence is needed for every assurance engagement. The quantity (sufficiency) and quality (appropriateness) of evidence available will be affected by:
- The characteristics of the subject matter. For example, when the subject matter is future oriented, less objective evidence might be expected to exist than when the subject matter is historical.
 - Other non-subject matter characteristics. For example, when expected evidence is not available to the practitioner, probably due to the timing of his appointment, an entity's document retention policy or some other restriction imposed by the responsible party.
5. Assurance Report – The practitioner gives a written report containing a conclusion that conveys the assurance obtained as to whether the subject matter conforms, in all material respects, to the identified criteria. For example, an audit of financial statements provides an opinion on conformity with standards (IFRS) and other regulatory framework.

2.3.2 Objectives of an Assurance Engagement

The objective of an assurance engagement depends on the level of assurance given. ISAE 3000 *Assurance engagements other than audits or reviews of historical financial information* distinguishes between two forms of assurance engagements:

- Reasonable assurance engagements
- Limited assurance engagements

The objective of a *reasonable assurance engagement* is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the assurance practitioner's conclusion.

The report (conclusion) would usually be expressed in a positive form, giving a "reasonable assurance" that the subject matter conforms in all material respects, with criteria. This indicates that given the evidence gathering procedure and the characteristics of the subject matter, the practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level. Thus, for this type of opinion, a significant amount of testing and evaluation is required to support the conclusion. The opinion on audit of financial statements is an example of reasonable assurance report.

Limited assurance is a lower level of assurance. The nature, timing and extent of procedures carried out by the practitioner would be limited compared with what is required in a reasonable assurance engagement. The report/conclusion could be expressed in negative form of words. For example, "nothing has come to our attention that causes us to believe that subject matter (e.g. historical financial statements) does not conform, in all material respects, to criteria (e.g. IFRS)." This form of report conveys a "limited assurance", indicating that the practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to a moderate level.

3.6 Other Assurance Engagements

Review Engagements

Assurance engagements include a range of assignments, from external audit to review engagements.

The objective of a review engagement is to obtain limited assurance about whether the subject matter information is free from material misstatements. Thus, a review can provide a cost-efficient alternative to an audit where an audit is not required by law.

Types of review engagements: There are two types of review engagements, namely, *an attestation engagement* and *a direct engagement*.

An attestation engagement: This is a form of engagement in which the practitioner issues a report/conclusion about the reliability of an assertion made by another party. Though the subject matter is not measured by the practitioner, he concludes whether or not the subject matter is free from material misstatement. For example, in a review of CSR or sustainability report prepared by management, management measures and evaluates the extent to which the company has achieved its targets, and the practitioner provides a conclusion as to whether the measurement and evaluation is free from material misstatements.

A direct engagement: Here, the underlying subject matter is measured and evaluated by the practitioner, who presents a conclusion on the reported outcome in the assurance report. For example, an engagement where the practitioner is engaged to carry out a review of the effectiveness of a company's system of internal controls; the practitioner would evaluate the internal controls and then issue an assurance report explaining the outcome of the review..

SELF ASSESSMENT QUESTION

1. What is an assurance engagement?
2. What qualification does a person need to possess before he/she can be qualified to be an auditor?

4.0 CONCLUSION

Audit and Assurance services are regulated to protect the interest of the user public. Sources of regulation include the Company law, Auditing standards and ethical guidance given by the professional accountancy bodies. Relevant provisions of the Companies and Allied Matters Act, 2004 govern the appointment, qualification, duties/powers as well as the remuneration, report and removal of the independent auditor in Nigeria.

An Assurance engagement is any engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. An audit is

a form of an assurance engagement.

5.0 Summary

In this unit, the purpose of regulating audit and assurance services and the sources of regulation were discussed. The unit also explained the legal provisions relating to the external auditor. Types and elements of Assurance engagements were also discussed.

6.0 TUTOR-MARKED ASSIGNMENT

- 1) What is an assurance engagement? List and briefly discuss the elements of an assurance engagement.
- 2) Audit and Assurance services are regulated primarily for the public interest. One of the sources of regulation is guidance given by the Companies and Allied Matters Act CAP C.20 LFN, 2004.

Required:

Describe the provisions of the Companies and Allied Matters Act CAP C.20 LFN, 2004 regarding:

- i. The appointment of the auditor (3 marks)
- ii. The remuneration of the auditor (2 marks)
- iii. Rights of the auditor (3 marks)
- iv. Liability of auditors for negligence (2 marks)

(Total 10 marks)

7.0 References/further reading

Ige, B (2008). Introduction to Auditing.

FGN (2004). Companies and Allied Matters Act. Lagos: Government Press.

Soyemi, K.A (2014). Auditing and Assurance Services. Abeokuta: LekSilicon Publishing Company Ltd

UNIT 3: AUDIT PLANNING AND STRATEGY

Content

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Nature of and need for planning an Audit engagement

3.2 Planning an Audit of Financial Statements

3.3 Summary of ISA 300, Planning an Audit of Financial Statements

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3.5 Changes to the audit strategy and the audit plan

3.6 Documentation

3.7 Direction, supervision and review

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 Introduction

Audit planning plays a key role in ensuring a successful audit. This unit takes you through the background work that has to be done before an audit is embarked upon. Various audit planning methods are available and could be used depending on the audit assignment the organisation is presented with.

2.0 Objectives

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

1. discuss the benefits of planning an audit

2. understand the requirements of ISA 300 for planning an audit of a financial statement.
3. Discuss the matters to be considered when establishing an audit strategy.

3.0 Main Content

3.1 Nature of and need for planning an Audit engagement

Audit planning involves the formulation of the general strategy for an audit and sets the direction for the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the audit programme. **Audit planning** is a vital area of the audit primarily conducted at the beginning of audit process to ensure that appropriate attention is devoted to important areas, potential problems are promptly identified, work is completed expeditiously and work is properly coordinated. The nature and extent of planning activities will vary according to the size and complexity of the entity, the auditor's previous experience with the entity, and changes in circumstances that occur during the audit engagement.

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. However, in planning an audit, the auditor considers the timing of certain planning activities and audit procedures that need to be completed prior to the performance of further audit procedures.

Adequate planning of audit work aims at:

1. Establishing the intended means of achieving the objectives of the audit
2. Assisting in the direction and control of the work
3. Helping to ensure that attention is devoted to critical aspects of the audit
4. ensuring potential problems are identified and resolved on a timely basis and that the audit engagement is properly organized and managed.
5. assisting in the proper assignment of work to engagement team members, facilitating the direction and supervision of engagement team members and the review of their work, and assisting, where applicable, in coordination of work done by auditors of components and experts.

6. Ensuring that the work is completed expeditiously
7. Facilitating review of the audit work.

3.2 Planning an Audit of Financial Statements

The auditor should plan the audit so that the engagement will be performed in an effective manner. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level.

At the planning stage, the engagement partner holds a meeting with members of the engagement team where experiences are shared for the benefit of all and for the purpose of enhancing the effectiveness and efficiency of the planning process.

During this meeting, the engagement partner will discuss the audit and its associated risks with the team members, and inform them of:

- Their responsibilities
- The objectives of the work to be performed
- The nature of the client's business
- Risk-related issues and other problems that may arise and
- The detailed approach to the audit assignment.

The planning activities will include:

- the analytical procedures to be applied as part of risk assessment procedures,
- obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework,
- the determination of materiality levels,
- the involvement of experts, if need be, and
- the performance of other risk assessment procedures prior to performing further audit procedures at the assertion level for classes of transactions, account balances, and disclosures.

As audit procedures are performed, the auditor considers how the conclusions drawn affect the risk assessment and resulting nature, timing and extent of further planned audit procedures.

3.3 Summary of ISA 300, Planning an Audit of Financial Statements.

When does audit planning take place?

Naturally, it is reasonable to assume that planning occurs towards the start of an audit engagement. However, according to ISA 300, planning should not be seen as a discrete and separate part of the overall audit. Planning often begins shortly after, or in connection with, the completion of the previous audit, for example, with a review of issues that were discussed with management, such as control deficiencies or unadjusted errors. Such matters are relevant to the next year's audit and need to be considered when planning.

Similarly, the audit plan may be revised as the audit progresses, and should not be viewed as being fixed in place once the main planning phase has ended. For example, a significant event may take place as the audit is in progress, meaning that the audit plan needs to be reviewed. As earlier noted, the nature and extent of planning activities depends on the size and complexity of the audit client, previous experience of the audit firm with the client, and any changes in circumstance that may occur during the audit.

Preliminary activities

ISA 300 contains a requirement that the auditor shall undertake the following activities at the beginning of the current audit engagement

- Performing procedures regarding the continuance of the client relationship and the specific audit engagement.
- Evaluating compliance with relevant ethical requirements, including independence
- Establishing an understanding of the terms of the engagement.

These requirements are also contained in **ISA 220**, *Quality Control for an Audit of Financial Statements* and **ISA 210**, *Agreeing the Terms of Audit Engagements* and remind us that planning is a wider activity than just obtaining understanding of the business and performing risk assessment.

Audit strategy and audit plan

ISA 300 states that audit planning activities should:

- establish the overall audit strategy for the engagement
- develop an audit plan.

Audit strategy

The audit strategy sets out in general terms how the audit is to be conducted and sets the scope, timing and direction of the audit. The audit strategy then guides the development of the audit plan, which contains the detailed responses to the auditor's risk assessment. An underpinning principle of audit planning under the clarified ISAs is that the audit plan should contain detailed responses to the specific risks identified from obtaining an understanding of the audited entity.

Matters to consider when establishing the audit strategy

ISA300 requires the auditor to consider specific matters when establishing the audit strategy, and provides a list of typical matters to be considered in its appendix. These matters include:

a. Identify the characteristics of the engagement that define its scope

Some audit engagements have specific characteristics that widen the scope than the audit of other entities. For example, a group audit engagement or the audit of a multinational company will both have wider scopes than an audit of a small, owner-managed entity. Matters such as the ability to use the work of internal auditors, the need to liaise with external service organisations, and the effect of IT on audit procedures are also relevant. The scope is also affected by the applicable financial reporting framework, the nature of the audited entity's business and whether it operates business segments, the business activities conducted, and the availability of client personnel and data.

b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required

Reporting requirements will vary from audit to audit. For example, some entities have additional

reporting requirements to comply with corporate governance regulations or industry requirements, and the auditor must understand these requirements from the start of the audit. The nature of other communications that may be necessary during the audit should be considered, such as liaison with component auditors, and communications to management and to those charged with governance.

c. Consider the factors that are significant in directing the audit team's efforts in the auditor's professional judgment

The strategy must consider issues to do with quality control, such as how resources are managed, how the audit is directed and supervised, when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

d. Consider the results of preliminary engagement activities and knowledge gained on other engagements

This includes the initial assessments of materiality, risks identified from preliminary activities such as fraud risks, significant events that have occurred at the entity or in the industry in which it operates since the last audit, and the results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them. The audit firm may also have performed other services for the client that may be relevant in determining the audit strategy, for example, reviews of business plans or cash flow forecasts.

e. Ascertain the nature, timing and extent of resources necessary to perform the engagement

One of the main objectives of developing the audit strategy is to effectively allocate resources to the audit team, for example, the use of specialists on particular areas of the audit, or building a team of highly experienced auditors for a potentially high-risk audit engagement. If the audit is time pressured due a tight deadline, then more resources will need to be allocated to ensure that all necessary audit work is completed, and can be reviewed in time to meet the deadline.

3.4 Audit plan

ISA 300 states that once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking in to account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.

Therefore it is not necessarily the case that the audit strategy is prepared and completed before the audit plan is devised, and in practice it is typical for the two to be developed together.

The audit plan is a detailed programme giving instructions as to how each area of the audit will be conducted. In other words, the audit plan details the specific procedures to be carried out to implement the strategy and complete the audit.

ISA 300 provides guidance on what should be included in the audit plan, stating that the audit plan should describe:

1. the nature, timing and extent of planned risk assessment procedures
2. the nature, timing and extent of planned further audit procedures at the assertion level
3. other planned audit procedures that are required to be carried out so that the engagement complies with ISAs.

Typically an audit plan will include sections dealing with business understanding, risk assessment procedures, planned audit procedures i.e. the responses to the risks identified and other mandatory audit procedures.

3.5 Changes to the audit strategy and the audit plan

The audit strategy and audit plan are not fixed once the planning stage of the audit is complete. It is important that both are updated and changed as necessary as the audit progresses. For example, as a result of unexpected events, or changes in conditions, the auditor may need to modify the

overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures, for example, an event may take place after audit planning has been initially completed which creates doubt over going concern. Or, as a result of performing planned audit procedures additional information may come to light which may lead the auditor to amend initial risk assessment, or level of performance materiality, for all, or part, of the audit.

3.6 Documentation

ISA 300 requires that the audit strategy and audit plan be thoroughly documented. A record of significant changes made to the audit strategy and audit plan is needed.

Documentation is crucial, because key decisions about how the audit will be performed are contained in the audit strategy and audit plan. The documentation should therefore include the response made by the auditor to any significant changes that occurred during the audit.

The audit strategy and audit plan do not need to be documented in a particular way. Some audit firms use memoranda, others checklists. Some use standardised documentation such as standardised audit programmes while others tailor the specific form of the documentation to each audit engagement. The form of the documentation does not matter as long as it provides a clear record of how the audit was planned.

3.7 Direction, supervision and review

ISA 300 requires that the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

In order to perform a high quality audit, it is crucial that the audit plan includes the detail as to how supervision and review should be conducted during the audit. Inadequate supervision and review can lead to the audit team making errors, for example, selecting inappropriate items for sampling, or failing to properly conclude on audit procedures performed.

The amount of detail included in the audit plan in relation to supervision and review will depend on factors such as the size and complexity of the entity being audited, the assessed risk of material misstatement, and the capabilities and competence of the audit team members.

Additional considerations in initial audit engagements

The final section of **ISA 300** relates to initial audit engagements, and requires the auditor to perform client and engagement acceptance procedures (as also required by **ISA 220**), and also to communicate with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. The **ISA** recognises that for an initial audit engagement, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.

4.0 Conclusion

This chapter discussed audit planning and its importance and the standards relevant to audit planning. Without proper planning, the direction, supervision and review of the audit work will lack cohesion and the quality of the audit is likely to be in doubt.

5.0 Summary

Audit planning is a vital area of the **audit** primarily conducted at the beginning of the **audit** process to ensure that appropriate attention is devoted to important areas, potential problems are promptly identified, work is completed expeditiously and work is properly coordinated.

6.0 TUTOR MARKED ASSIGNMENTS

1. Discuss the benefits of audit planning.
2. List and explain the matters to be considered in establishing an audit strategy.
3. Why is documentation important in the audit planning process?

7.0 References/Further reading

1. Ige. B (2008). Introduction to Auditing
2. Millichamp, A.H & Taylor, J.R (2011). Auditing, 11th Edition, London: BookPower/ELST
3. ACCA Study Text on Advanced Audit and Assurance.London: BPP Learning Media.
4. International standards on Auditing 200, 300 and 315.

UNIT 4: PROFESSIONAL ETHICS

Content

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Ethical Standards and Professional Responsibilities

3.2 Consequences of Unethical Behaviour

3.3 Auditor Independence

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 INTRODUCTION

This unit discusses the ethical guidelines for accountancy practice issued by the International Federation of Accountants (IFAC) and adopted by member bodies such as ICAN. The unit highlights the fundamental ethical principles applicable to all members of the accounting profession and the Statements that have varying applications to different member groups. Finally, the possible threats to the accountants' independence/objectivity and possible safeguards are explored.

2.0 Objectives

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

1. Discuss the fundamental ethical principles as stipulated by the IFAC code of ethics/ICAN

Rules of professional conduct for members.

2. Explain the concept of independence and discuss the possible ethical threats to auditor's objectivity and independence
3. State the possible safeguards to any identified ethical threat to objectivity and independence.
4. Discuss the consequences of unethical behaviours by the accountant.

3.0 Main Content

3.1 Ethical Standards and Professional Responsibilities

The standards as contained in both the IFAC and ICAN codes are in two categories namely:

1. Fundamental Principles and
2. Statements.

3.1.1 Fundamental Principles.

These are drawn from the duties owed by all members of the profession, whether in practice or not. They constitute basic advice on professional behaviour.

A professional accountant shall comply with the following fundamental principles

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

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

- (a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

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

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

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

(c) *Professional Competence and Due Care* – A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques. The Accountant has the obligation to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing

professional development enables a professional accountant to develop and maintain the capabilities to perform competently within the professional environment.

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

(d) *Confidentiality* – A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose. The Accountant has the obligation to respect the confidentiality of information acquired as a result of professional and business relationships. He should therefore, neither disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for his personal advantage or that of third parties.

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

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

A professional accountant shall maintain confidentiality of information disclosed by a prospective client or employer.

A professional accountant shall maintain confidentiality of information within the firm or employing organization.

A professional accountant shall take reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality. The professional accountant shall not, however, use or disclose any confidential information either acquired or received as a result of a professional

or business relationship.

Circumstances where professional accountants may disclose Confidential Information

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

- (a) Disclosure is permitted by law and is authorized by the client or the employer;
- (b) Disclosure is required by law, for example:
 - (i) Production of documents or other provision of evidence in the course of legal proceedings; or
 - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and
- (c) There is a professional duty or right to disclose, when not prohibited by law:
 - (i) To comply with the quality review of a member body or professional body;
 - (ii) To respond to an inquiry or investigation by a member body or regulatory body;
 - (iii) To protect the professional interests of a professional accountant in legal proceedings; or
 - (iv) To comply with technical standards and ethics requirements.
- (d) When disclosure is required for the public interest.

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

- Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant;
- Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or

unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any;

- The type of communication that is expected and to whom it is addressed; and
- Whether the parties to whom the communication is addressed are appropriate recipients.

(e) *Professional Behaviour* – A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. A professional accountant should carry out professional services in accordance with the relevant technical and professional standards and to comply with relevant laws and regulations and avoid any action that discredits the profession.

The principle of professional behaviour imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession.

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

- (a) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or
- (b) Make disparaging references or unsubstantiated comparisons to the work of others.

3.1.2 Statements

Statements provide more elaborate discussions on what is expected of members in certain circumstances. Most of the statements are relevant to members in practice and where appropriate, to employees of practicing firms but not to other members.

The statements as stated in ICAN code are as given in the table below.

Table 3.1.1 ANALYSIS OF THE STATEMENTS OF ETHICAL STANDARDS

S/NO	SUBJECT MATTER	THOSE TO WHOM APPLICABLE
1.	Integrity, Objectivity and Independence Preface – integrity, objectivity, framework, etc.	All Members
	Introduction – Safeguarding Objectivity Section A – Objectivity and Independence and the Audit.	All Members, Practicing Members, Affiliates and employees of practicing Firms.
	Section B – Objectivity and independence in financial reporting and similar non-audit roles.	Practicing Members, affiliates and employee of practicing firms.
	Section C – Objectivity and independence in professional roles other than covered in sections A& B.	Practicing Members, Affiliates and employees of Practicing firms.
	Section D – Definitions	All Members
2.	Conflicts of Interest	Practicing Members, Affiliates and Employees of practicing firms.
3.	Confidentiality	All members
4.	Changes in a professional appointment	Practicing Members, Affiliates and Employees of practicing firms.
5.	Consultancy	Practicing Members, Affiliates and Employees of practicing firms.
6.	Associations with non-members	Practicing Members, Affiliates and Employees of practicing firms.

7.	Fees	Practicing Members, Affiliates and Employees of practicing firms.	
8.	Obtaining Professional work	Practicing Members, Affiliates and Employees of practicing firms.	
9.	Names and Letterheads of practicing firms	Practicing Members, Affiliates and Employees of practicing firms.	
10.	Second and other opinions	All members	
11.	Members in business	Members in business	
12.	Enforcement of ethical standards.	All members.	

These Statements more or less highlight ‘rules’ for ethical conduct, and the section of the code on enforcement of ethical standards and enforcement procedures define the powers of the Institute of Chartered Accountants of Nigeria in ensuring compliance to the rules by its members.

The said section states:

1. The power of the Institute to enforce ethical standards is derived from the ICAN Act 1965 and this power is conferred on the Disciplinary Tribunal, which is independent of the Council.
2. The investigating panel considers complaints against the conduct of members and initiates disciplinary action by referring appropriate cases to the Disciplinary Tribunal.
3. Where the complaint is against a member of a firm having more than one partner, all partners in the firm as at the time of complaint will be jointly and severally held.
4. Where a complaint of misconduct is brought against a member, such a member is required to furnish his defence to the Investigating panel within 14 days of notification by the panel.
5. Where the member fails to respond within this specified time, a first reminder is sent requesting that he sends his defence or reaction within 7 days from the date of receipt of the reminder.

6. If the member fails to respond after the first reminder, a formal charge of contempt will be preferred against the member before the Disciplinary tribunal.
7. If the members address cannot be readily obtained, the Panel shall publish the invitation on a National Newspaper after which if there is no response within a reasonable time, it shall be treated as contempt of the Institute and is sanctionable by the Disciplinary Tribunal.
8. The Disciplinary Tribunal is the only body that can determine, subject to the right of appeal, if a complaint of misconduct is proved.
9. From the Accountants' Disciplinary Tribunal, a member has a right of appeal to the Court of Appeal.
10. If a member of the Institute has been declared guilty of professional misconduct by the Tribunal, the member shall not be eligible to serve on the Institute's council or any of the Institute's committees for a period of 5 years from the date of re-admission into membership or studentship.

3.2 CONSEQUENCES OF UNETHICAL BEHAVIOUR

Unethical behaviour of the professional Accountant refers to failure to comply with the expected normal moral standards of a profession. It is in other words, termed professional misconduct.

As stated above, the power of ICAN to enforce ethical standards is conferred on the Accountants Disciplinary Tribunal, with powers equivalent to those of a High Court. Any appeal against its verdict goes to the Appeal court. The investigating panel considers complaints against the conduct of members and is empowered to initiate disciplinary action by referring appropriate cases to the Disciplinary Tribunal for adjudication.

Sanctions commonly imposed for professional misconduct include:

1. Reprimand

2. Payment of costs
3. Fine
4. Withdrawal of practicing rights
5. Suspension from membership for a period of time
6. Expulsion from membership.

3.3 Auditor Independence

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

Independence is described by the IFAC (2009) Code as:

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

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

- i. *Independence of mind*: The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and profession scepticism.
- ii. *Independence in appearance*: The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant

information, including safeguards applied, would reasonably conclude a firm's or a member of the assurance team's integrity, objectivity and professional scepticism had been compromised.

3.3.1 Potential threats to independence and Objectivity

There are five general sources of potential threats to independence and objectivity identified by the revised Code.

(a) Self-interest threat

This occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest with, an assurance client e.g. a direct financial interest or material indirect financial interest in an assurance client. According to the Code examples which create self-interest threats for a professional accountant in public practice include:

- (i) A firm entering into a contingent fee arrangement (i.e. fees are contingent upon the findings or results of services) that relates to an assurance engagement;
- (ii) A firm which is concerned about the chance happening of losing a significant client;
- (iii) A member of the audit team entering into employment deals with the audit client;
- (iv) A firm having undue dependence on total fees receivable from a client;
- (v) A member of the assurance team having a direct financial interest (e.g. ownership of client equities or financial instruments) in the assurance client; and
- (vi) A member of the assurance team having a significant close business relationship with an assurance client.

(b) Self-review threat

This occurs when any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-valuated in reaching conclusions on the assurance engagement or when

a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement. Examples of circumstances which create self-review threat for a professional accountant in public practice include:

- i). A firm issuing an assurance report on the effectiveness of the operation of a financial system after designing or implementing it.
- ii). A firm, having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- iii). A member of the assurance team being or having recently been a director or officer of the client.
- iv). A member of the assurance team being or having recently been employed in a position to exert significant influence over the subject matter of the engagement.
- v). The firm performing a service for a client that directly affects the subject matter information of the assurance engagement.

(e) **Advocacy threat**

This occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgement to that of the client. Examples include dealing in, or being a promoter of, shares or other securities in an assurance client and acting as an advocate on behalf of an assurance client in litigation.

(f) **Familiarity threat**

This is the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work. Examples of circumstances which may create familiarity threats include:

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

(g) **Intimidation threat** (for example, threats of replacement due to disagreement).

This occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client e.g threat of replacement over a disagreement with the application of an accounting principle.

Examples of circumstances which may create intimidation threats for a professional accountant who is in public service include:

- (i) A firm being threatened with dismissal from a client engagement;
- (ii) A firm being threatened with litigation by the client;
- (iii) A firm being pressurized to reduce inappropriately the extent of work performed so as to reduce fees;

(iv) An audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction; and

(v) A professional accountant being informed by a partner of the firm that a planned promotion will not take place except the accountant agrees with an audit client's inappropriate accounting treatment.

3.3.2 Possible Safeguards

There are two general categories of safeguards identified by the Code:

(i) Safeguards created by the profession, legislation or regulation

(ii) Safeguards within the work environment.

Examples of safeguards created by the profession, legislation or regulation:

(i) Educational training and experience requirements for entry into the profession;

(ii) Continuing professional development requirements;

(iii) Corporate governance regulations;

(iv) Professional standards;

(v) Professional or regulatory monitoring and disciplinary procedures;

(vi) (External review by a legally empowered third party of the reports, returns, communication or information produced by a professional accountant.

Examples of safeguards in the work environment (that is, within the Audit firm):

(i) Involving an additional professional accountant to review the work done or otherwise advise as

necessary;

(ii) Consulting an independent third party, such as a committee of independent auditors, a professional regulatory body or another professional accountant;

(iii) Rotating senior personnel;

(iv) Discussing ethical issues with those in charge of client governance;

(v) Disclosing to those charged with governance (through the audit committee) the nature of services provided and extent of fees charged.

(vi) Involving another firm to perform or re-perform part of the engagement.

vii) Leadership stressing the importance of independence, having written independence policies and designating a member of senior management to oversee the adequate functioning of the safeguarding system.

Hayes, Dassen, Schilder and Wallage posit a third category of safeguard, that is, **safeguard within the Assurance Client**.

Examples of such safeguard include:

i). Ratification by the audit committee of the appointment of the audit firm (the trend is towards appointment of the auditor by the Audit committee);

ii). Competent personnel in the employment of client;

iii). Client is committed to fair financial reporting;

iv). The client has internal procedures that ensure objective choices in commissioning non-assurance engagements;

v). client has a corporate governance structure such as audit committee, that provides oversight of

the audit firm's services.

4.0 CONCLUSION

The Accountant should strive to adhere to ethical principles as it is fundamental to his professional practice as an auditor. Compliance with ethical principles is central to the the credibility of the audit report issued by the accountant. The public's acceptance of and reliance on the auditor's work is by extension its acceptance of and reliance on the accounting profession. The auditor should therefore be careful of situations that create threats to his objectivity and independence.

5.0 SUMMARY

This unit discussed the fundamental ethical principles based on IFAC's Code of Ethics as well as ICAN's Rules of Professional Conduct and Guide for Members. It also examined threats to the accountant's independence and objectivity and possible safeguards to the identified threats are also suggested.

6.0 TUTOR MARKED ASSIGNMENT

1. Independence is a trait all external auditors must imbibe. What are the factors that can impair audit independence?
2. Discuss the fundamental ethical principles contained in IFAC's Code of Ethics. Under what circumstances may an auditor disclose client's confidential information to third parties?
3. What is Advocacy threat? Discuss possible safeguards against advocacy threat.

7.0 References/further reading

1. ACCA (2014). Study Text on Advanced Audit and Assurance. London: BPP Learning Media.
2. ICAN(2014): Advanced Audit and Assurance Study text. UK: Emile Woolf International
3. Hayes, R et al(2005), Principles of Auditing: An introduction to international standards on auditing. England: Prentice Hall (Pearson Education Publishers).
4. ICAN (2009). Rules of Professional behaviour and conduct for members.

UNIT5: CORPORATE GOVERNANCE

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1.0 INTRODUCTION

In this unit, we will discuss the important concept of corporate governance. Corporate governance failures have been cited as one of the reasons for the failures of global companies, such as Enron, World com etc. This unit explores the nature and significance of corporate governance and the roles of key players such as the board, the audit committee, internal audit function as well as the external auditor, in the governance framework.

2.0 Objectives

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

1. Explain corporate governance.
2. explain the factors that have heightened the concern for good corporate governance practices in recent times.
3. statethe significance of good corporate governance and the principles that govern stakeholder relationships.
4. discuss the responsibilities of the Board of directors and the Audit committee in the corporate governance framework in line with provisions of the National Code of Corporate Governance (Private sector).

3.0 Main Content

3.1 Definitions

The following are the various definitions of corporate governance.

1. The set of mechanisms through which outside investors are protected from expropriation by insiders (including management, family interests and/or government) – Nganga, Jain and Artivor (2003).
2. Corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investments – Shleifer&Vishny. It is a way of making sure that managers do not misappropriate the capital or invest in bad projects.

3. Corporate governance is the process and structure used to direct and manage a business and the affairs of the corporations with the objective of enhancing shareholder value which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board and management- Toronto Stock exchange.
4. Corporate Governance is “the system by which companies are directed and controlled.” – Cadbury Committee.
5. Organization for Economic Co-Operation & Development. (OECD): Corporate governance comprehends that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance to achieve the corporation’s primary objective.

The focus of corporate governance is on the dilemma that results from the separation of ownership and control; it addresses the Principal- Agent relationship between shareholders and directors on the one hand and the relationship between company agents and stakeholders on the other. All other parties, e.g. customers, suppliers, employees, government and the general public, have interest on the success of the entity and thus entitled to balanced, transparent and fair reports from those charged with governance.

3.2 Nature, Scope & Significance of Good Corporate Governance

Nature of corporate governance

1. Good Corporate governance encompasses efficient and effective asset management in line with regulatory, compliance and risk management principles.
2. Good Corporate governance evidences the commitment of management to adhere to conduct which is recognized as sound and appropriate throughout the world.
3. It promotes the financial stability and profitability of a firm.

4. It fosters disaster recovery and ensures the going concern status of a company.
5. Good corporate governance ensures the compliance and enforcement of best practices.
6. It embraces sound and enduring business procedures, processes and policies. It mitigates risks and brings about optimal operational activities.
7. It facilitates internal audit monitoring and evaluation of internal controls designed to mitigate all kinds of risks.

Scope of corporate governance

Corporate Governance covers the following areas:

- a. Compliance with corporate and company law.
- b. Compliance with Code of best practices
- c. Risk management aimed at safeguarding the assets of the organization from expropriation and
- d. Installation and maintenance of internal audit functions.

Significance of corporate governance

The significance of corporate governance lies in the fact that good corporate governance enhances:

- i. The ability of a company to produce quality goods or supply efficient and economic services at the least possible cost;
- ii. The objective of ensuring appropriate and adequate controls over a company's activities and operations;
- iii. The ability of the enterprise to generate competitive and reasonable return on investment for investors;

- iv. The ability of the organization to deter and prevent fraud and fraudulent practices.

3.3 Causes of Heightened Interest/discussions on Corporate Governance

1. **Bankruptcies, Fraud and mismanagement:** These are the major reasons why CG has been in the spotlight in recent years. Notable among these cases are Waste Management, Worldcom, BCCI, Orange County, Xerox, HIH Insurance, Enron etc.
2. **The influence of public, customers and media:** There has been increasing demand for shareholder role in governance and also an increasing influence of customers and public/media opinion on the governance of corporations.
3. **Globalization of the capital markets:** Globalization encourages the harmonization of laws and regulations and institutional investors are increasingly making investment decisions on the basis of whether an enterprise adopts global best practices in its corporate governance.
4. **Developments in Information Technology:** IT is a major enabler of the new economy and has led to fundamental changes in financial reporting languages and in disclosure of information for decision making. IT is thus currently taking centre stage in CG developments and discussion.

Others include

- Inequality in the treatment of investors;
- Fraudulent financial reporting;
- Excessive risk taking
- Poor management;
- Deficient Internal control systems; and
- Excessive Influence.

3.4 Corporate Governance Code in Nigeria

In response to calls for the adoption of global best practices in Corporate governance in Nigeria, The Minister of Trade and Investment, on 17th January, 2013 set up a Steering Committee on the

National Code of Corporate Governance to harmonize and unify all the existing sectoral corporate governance codes in Nigeria. These sectoral codes included the Code of Corporate Governance for Banks in Nigeria Post-Consolidation 2006, Code of Corporate Governance for Licensed Pensions Operators 2008, Code of Corporate Governance for Insurance Industry in Nigeria 2009, SEC Code of Corporate Governance in Nigeria 2011 and CBN Code of Corporate Governance for Banks and Discount Houses 2014.

The Committee's terms of reference were to develop a National Code of Corporate Governance that will enable the Financial Reporting Council of Nigeria, among other things, to:

- (a) Promote the highest standards of corporate governance;
- (b) Promote public awareness about corporate governance principles and practices;
- (c) Act as the national coordinating body responsible for all matters pertaining to corporate governance in both private and public sectors of the Nigerian economy;
- (d) Encourage sound systems of internal control and information systems control to safeguard stakeholders' investment and assets of public interest entities;
- (e) Promote sound financial reporting and accountability based on true and fair financial statements duly audited by competent independent Auditors; and
- (f) Ensure that audit committees of public interest entities keep under review the scope of audit and its cost effectiveness, the independence and objectivity of the auditors.

The Committee produced two Codes, namely:

- National Code of Corporate Governance for the private sector (effective 17th October, 2016);
- Not-for-Profit Organizations: Code of Corporate Governance (effective 17th October, 2106); and

The Code of Governance for the Public Sector is at ED (Exposure Draft) level.

Private Sector Code

Our focus in this course is on the Private sector code. This code applies to:

- (a) All public companies (whether listed or not);
- (b) All private companies that are holding companies or subsidiaries of public companies; and
- (c) Regulated private companies (that is, private companies that file returns to any regulatory authority other than the Federal Inland Revenue Service and the Corporate Affairs Commission,

except such companies with not more than eight (8) employees).

3.5 Stakeholder Relationships

The stakeholders of a company include existing and potential investors, employees, loan and trade creditors, customers and all those that are impacted in one way or the other by the company's operations, products and services.

The ethical rules of behaviour or principles that govern stakeholder relationships include:

1. **The principle of fairness** – this involves objective and equitable handling of all stakeholder interests. It does not necessarily mean treating everybody the same way.
2. **The principle of co-operation, solidarity or community** – Team work is seen as being paramount to the achievement of corporate objectives. This principle aims at avoiding sub-optimality in the pursuit of the goals of the organization.
3. **The principle of rationality** – This demands that people act intelligently and reasonably, avoiding self-interests. Consideration should be towards the means to attain most efficiently and effectively the set objectives and the quality and adequacy of resources deployed in relation to desired ends.
4. **The principle of refraining from a willed harm to others** – Actions should not be deliberately taken to put to a disadvantage any group of stakeholders. Actions that are not intended as instruments of achieving corporate objectives should be avoided.
5. **The principle of role responsibility** – Stakeholders should pursue faithfully their role responsibilities. They should deploy their skills and competences for the overall benefit of the organization and all stakeholders.

A symbiotic relationship between all stakeholders yields synergistic result on corporate governance. Such impact can be seen in the following areas:

- a) Raising the standard of corporate governance attracts investments including FDIs. Investors look for strong board effectiveness, transparency, accountability and financial probity as key drivers of governance in organizations.
- b) There is a strong positive association between the commitment and loyalty of employees and the moral index of an organization. Where the leadership is seen to be selfish and self-serving, the employees help themselves to improve their welfare.
- c) Quality operations of the company, through its goods and services improve the quality of life of customers. Its CSR also impacts the lives of the immediate community/environment. Suppliers also continue to supply when the terms of payment are adhered to by the company. Overall, every stakeholder benefits.
- d) Government's role in giving the desired direction by creating the enabling environment, including strong institutions and infrastructure, is important. The Government's role is the fulcrum on which every enterprise's CG revolved.

3.6 Roles of certain key players in Corporate Governance

Board of Directors

Section 3 of the National Code of Corporate Governance states that the main purpose of the board is to provide entrepreneurial, strategic and ethical leadership to a company, ensure that management is acting in the best interest of owners and other stakeholders.

Responsibilities of the Board

Section 4 of the Code gives a non-exhaustive list of the responsibilities of the board as follows:

1. The board that shall govern, direct and be in effective control of the affairs of the company. Every board shall have a Charter setting out its responsibilities.

2. The board being central in corporate governance shall serve as the link between the stakeholders and the company. The board's paramount responsibility is the positive performance of the company in creating value for all its stakeholders.
3. The board shall exercise leadership, enterprise, integrity and judgment in directing the company so as to achieve continuing survival and prosperity of the company.
4. The board shall ensure the establishment and implementation of a succession plan, appointment, training and remuneration for both the board and senior management of the company.
5. The board is accountable to the shareholders and shall exercise the important role of identifying other stakeholders relevant to the business of the company and incorporate their expectations in its decisions.
6. The board shall set the company's values and standards (including ethical standards), and ensure that obligations to shareholders and other stakeholders are understood and met.
7. The appointment and removal of the head of the internal audit shall be the responsibility of the board on the recommendations of the statutory or Board Audit Committee (or both where they co-exist).
8. The board is responsible for the establishment of the company's risk management framework as well as oversight over its implementation.
9. The board shall be responsible for Information Technology governance.
10. The Board shall be responsible for the company's internal control system, financial control and reporting.

Internal Audit Function

The internal audit function shall be headed by a member of senior management and can only be removed by the board on the recommendation of the Statutory Audit Committee (and board audit committee, in the case of companies with two audit committees). A public interest Entity shall not

outsource its internal audit functions.

The duties of the internal audit function shall include:

- i. assisting the directors and management to maintain effective controls through periodic evaluation to determine the effectiveness and efficiency of the company's internal control systems and make recommendations for enhancement or improvement.
- ii. reporting at least once every quarter, to the audit committee meetings, on the adequacy and effectiveness of management, governance, risk and control environment, deficiencies observed and management mitigation plans.
- iii. establishing a risk-based internal audit process that provides a consistent basis for the provision of internal audit services and highlights the key steps and activities to be performed from the planning stage through to the reporting phase of the audit.
- iv. providing independent assurance on the robustness and effectiveness of the company's risk management process.
- v. liaising with other internal and external providers of assurances in order to ensure proper coverage and to minimise duplication of effort.
- vi. Annual risk assessment to identify emerging, as well as residual or existing risks.

The audit committee

Section 8.14 of the 2016 National Code of Corporate Governance makes provision for the establishment of audit committees namely statutory audit committee and Board audit committee by public companies. Every private company to which this code applies shall have a Board Audit Committee.

All members of an audit committee (whether statutory or board) shall have financial literacy and shall be able to read and interpret financial statements. At least one member of the committee shall be an expert and have current knowledge in accounting and financial management

The Board Audit Committee shall be composed of at least three members, all of whom shall be non-executive directors, a majority of whom shall be independent nonexecutive directors.

Duties and responsibilities

The 2016 National Code of Corporate Governance for private sector stipulates the following functions for the audit committee:

Consistent with section 359(3) and (6) of Companies and Allied Matters Act, Cap. C20, Laws of the Federation of Nigeria 2004, every public company shall establish a *Statutory Audit Committee* which shall perform the following functions:

- (a) Ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- (b) Review the scope and planning of audit requirements;
- (c) Review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- (d) Keep under review the effectiveness of the company's system of accounting and internal control;
- (e) Make recommendations to the board regarding the appointment, removal and remuneration of the external auditors of the company; and
- (f) Authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

Board Audit Committee

Without prejudice to the provision of the Companies and Allied Matters Act, CAP C20, Laws of the Federation of Nigeria 2004 every public company shall, in addition to a Statutory Audit Committee, have a *Board Audit Committee* which shall have the following additional responsibilities:

- (a) Exercise oversight over the integrity of the company's financial statements, compliance with legal and other regulatory requirements, assessment of qualifications and independence of external auditor, and performance of the company's internal audit function as well as that of external auditors;
- (b) Establish an internal audit function and ensure there are other means of obtaining sufficient assurance of regular review or appraisal of the system of internal controls in the company;
- (c) Ensure the development of a comprehensive internal control framework for the company,

obtain assurance and report annually in the financial report, on the operating effectiveness of the company's internal control framework;

(d) Oversee the process for the identification of significant fraud risks across the company and ensure that adequate prevention, detection and reporting mechanisms are in place;

(e) At least on a quarterly basis, obtain and review a report by the internal auditor describing the strength and quality of internal controls including any issues or recommendations for improvement, raised by the most recent internal control review of the company;

(f) Discuss the annual audited financial statements with management and external auditors;

(g) Discuss policies and strategies with respect to risk assessment and management;

(h) Meet separately and periodically with management, internal auditors and external auditors;

(i) Review and ensure that adequate whistle-blowing procedures are in place and that a summary of issues reported are highlighted to the chairman of the committee;

(j) Review, with the external auditor, any audit scope limitations or problems encountered and management's responses to same;

(k) Review the independence of the external auditors and ensure that where approved non-audit services are provided by the external auditors, there is no conflict of interest;

(l) Preserve auditor independence, by setting clear hiring policies for employees or former employees of independent auditors;

(m) Consider any related party transactions that may arise within the company or group;

(n) Invoke its authority to investigate any matter within its Charter for which purpose the company must make available the resources to the internal auditors with which to carry out this function, including access to external advice where necessary; and

(o) Report regularly to the board.

Risk Management Committee

Under section 8.15 of the Code, the board shall establish a risk management committee which shall be composed of a majority of non-executive directors. At least one of the non-executive directors shall be an independent non-executive director.

Duties of the Committee

The risk management committee shall have the duty to:

- (a) Assist the board in its oversight of the risk profile, risk management framework and the risk strategy as may be determined by the board.
- (b) Review the adequacy and effectiveness of risk management and controls in the company.
- (c) Exercise oversight over management process for the identification of significant risks across the company and the adequacy of prevention, detection and reporting mechanisms.
- (d) Undertake the review of the company's compliance level with applicable laws and regulatory requirements which may impact the company's risk profile.
- (e) Undertake periodic review of changes in the economic and business environment, including emerging trends and other factors relevant to the company's risk profile and make recommendations to the board as appropriate.
- (f) Review and recommend for approval of the board risk management procedures and controls for new products and services.
- (g) Ensure that Information Technology assets are managed effectively.
- (h) Review the company's Information Technology governance framework at least annually

A member of senior management of the company shall be charged with the responsibility of performing the risk function and shall be entitled to attend the meetings of the risk management committee

External auditors

Section 19 of the 2016 Code extensively deals with the strategic importance of external auditors in the governance framework, including prohibition of non-audit services as well as steps the audit firm should adopt in order to ensure quality audit. The requirements of the code include:

1. The Statutory and Board audit committees, either independently or jointly (where they co-exist) shall have the primary responsibility for making a recommendation to the board on the appointment, reappointment and removal of external auditors. The appointment of the first external auditor of a company, as well as subsequent appointments, shall be as stipulated by the Companies and Allied Matters Act, Cap. C20, Laws of the Federation of Nigeria 2004 (see unit 2).
2. The Code requires that listed and significant public interest entities shall engage joint external auditors for their statutory audit. These entities are those whose market capitalisation is not less than ₦1 billion and/or whose annual turnover is not less than ₦10 billion. Where the existing or first statutory auditor is an international firm, the second auditor who must be appointed by show of hands (in an Annual General Meeting) rather than by poll, shall be a national firm. Also, where an entity has a market capitalisation of not less than ₦300 billion and/or an annual turnover of not less than ₦50 billion, if the existing or first statutory auditor is an international firm, the second auditor, who must be appointed by show of hands (in an Annual General Meeting) rather than by a poll, shall be a national firm, or vice versa.
3. External audit firms shall be retained for no longer than ten years continuously. External audit firms disengaged after continuous service to a company for ten years may be considered for reappointment seven years after their disengagement. Where an auditor's aggregate or cumulative tenure has already exceeded ten years at the date of commencement of this Code, such auditor shall cease to hold office as an auditor of the company at the end of the financial year that this Code comes into force. An external auditor shall provide to the company only such other services as are approved by the board of directors on the recommendation of the audit committee. Such services **shall not** include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:
 - (a) Accounting and book keeping services;
 - (b) Internal audit services;
 - (c) Design and implementation of any financial information system;

- (d) Actuarial services;
- (e) Investment advisory services;
- (f) Investment banking services;
- (g) Rendering of outsourced financial services;
- (h) Management services;
- (i) Taxation services;
- (j) Performance evaluation of the board and its committees; and
- (k) Any other kind of services as may be proscribed by the regulators.

An auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Code shall cease rendering such services before the end of the first financial year after the date of the commencement.

4. Companies shall require external audit firms to rotate the audit partners assigned to undertake the external audit of the company *every five years*. To further ensure the auditor's independence:
 - a) No retired partner of an audit firm shall be appointed as a director of any company that had been, or still being audited or investigated by the firm from which the partner retired, until *five years after the disengagement* of the firm from such audit or investigation and/or the disengagement of the partner from the firm.
 - b) No partner or employee (Audit Manager and above) of an audit firm shall be employed by the company which the audit firm has audited until after a period of *not less than three years* after the person ceased to be in that position in that audit firm.

5. **Ensuring Audit quality**

Audit quality depends on a number of factors including, but not limited to, the quality of the individuals who conduct an audit. The external auditor must therefore ensure:

- (a) That the lead engagement partner and the audit team have the necessary knowledge and relevant skills to meet the company's audit requirements.
- (b) That the audit team provides quality audit services to the satisfaction of the Board Audit Committee or Statutory Audit Committee or both.

- (c) That the primary members of the audit team demonstrate the knowledge, skills and experience necessary to address the company's area of greatest financial reporting risk.
 - (d) That the audit team carries out a comprehensive and sound risk assessment, including especially an assessment of fraud risk.
 - (e) That the audit team is able to demonstrate, a good understanding of the company's business and industry and also the impact of the economic environment on the company.
 - (f) That the lead engagement partner and the audit team are satisfied with the quality of other engagement teams that perform other portions of the audit in various domestic and foreign locations.
 - (g) That the lead engagement partner and the engagement team are independent of the company and approach their work with a high level of objectivity and professional scepticism.
6. The regulator, by regulatory order may direct the company to change its auditors in general meeting, where the regulator is satisfied that an external auditor of a company has abused his office or acted in a fraudulent manner or colluded in any fraud in the company. The proceeding for the change of auditor shall be without prejudice to any sanctions that the regulator might impose on such erring auditor.
 7. There shall be no direct reciprocal change of the same firms of auditors taking the form of two audit firms succeeding each other as opposites in audits from which they have just mandatorily retired.
 8. Where the Board Audit Committee or the Statutory Audit Committee has made a recommendation for the appointment, re-appointment or removal of an external auditor, such recommendation can only be overridden by a 75% vote of the board's full membership and the fact of override should be disclosed in the annual report.
 9. Where External Auditors discover or acquire information during an audit that leads them to believe that the company or anyone associated with it has committed an indictable offence under the Companies and Allied Matters Act, Cap C20 Laws of the Federation on Nigeria 2004, any other Statute, or regulation(s), they must report this to the Regulator, whether or not such matter is or will be included in the Management Letter.

Remuneration Committee

The board is required to establish a remuneration committee which shall be composed of at least three members, all of whom shall be non-executive directors, a majority of whom shall be independent non-executive directors. The chairman of the remuneration committee shall be appointed by the board and he must be an independent nonexecutive director.

Duties

The duties of the remuneration committee shall include:

- (a) Development of a formal, clear and transparent procedure for the development of the company's remuneration policy.
- (b) Recommendation to the board on the company's remuneration policy and structure for all executive directors and senior management employees.
- (c) Recommendation to the board on the remuneration of non-executive directors.
- (d) Recommendation to the board on compensation payable to executive directors and senior management employees for any loss of office or termination of appointment to ensure that it is consistent with contractual terms, fair and not excessive.

Shareholders - Roles, rights and privileges

1. Election of directors and approval of the terms and conditions of their positions.
2. Ensuring that board implements decisions reached at the AGM.
3. Approve service contracts of directors that are to exceed 3 years.
4. Directors are to ensure appropriate venue for AGMs are chosen to enable every shareholder attend and vote;
5. Shareholders entitled to receive notice of AGM and Annual reports at least 21 days before the date of meeting.
6. A shareholder or group of shareholders, holding in aggregate not less than one per cent of the

share capital or shares of a company, shall be entitled to submit items for inclusion in the agenda of the annual general meeting of the company.

Principles of Corporate governance (OECD)

- a. Protection of shareholders right.
- b. Equitable treatment of all shareholders (Minority and foreign shareholders)
- c. Recognition of the rights of stakeholders as established by law
- d. Timely and accurate disclosure on all material matters
- e. Active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprise.
- f. Strategic guidance of the company, effective management of the board and the board's accountability to the company and shareholders.

3.7 Achieving Effective Corporate Governance

Key issues to address in order to achieve effective corporate governance revolve around the effectiveness of the board oversight functions in the following areas:

- i. risk management.
- ii. responsibility for internal control system.
- iii. independent and transparent system for recruitment, retention and remuneration of directors and top management.
- iv. communication with external auditors and ensuring their independence, and
- v. transparent reporting of corporate governance compliance process.

Therefore, regular reporting in the following areas is necessary for sound Corporate Governance:

- i. Risk management reports – analysis of current operational risks identification, assessment, treatment/strategy and monitoring.
- ii. Residual risk reports – details of issues not previously identified and not being managed.
- iii. Reports of independent expert analysis of technical matters, depending on the industrial sector.
- iv. Report of management over-rides of controls.
- v. Status of implementation of external auditor’s management letter,
- vi. Unimplemented recommendations of the internal audit.

4.0 Conclusion

This chapter discussed the nature, scope and significance of corporate governance. The principles that govern stakeholder relationships are highlighted and roles of key organs in the governance framework are enunciated.

5.0 SUMMARY

Corporate governance is defined as how an organisation is directed and controlled. Good corporate governance is germane to corporate survival and growth. Many of the high profile corporate failures in recent history have been associated with failure of corporate governance. Thus, the 2016 National Code of Corporate Governance provides a paradigm shift from the hitherto Corporate governance framework in Nigeria. It is important therefore that entities comply with the requirements of the National Code of Corporate Governance issued by the Financial Reporting Council of Nigeria.

6.0 Tutor marked assignment

- 1) Define corporate governance and explain the reasons for increase concern on good corporate governance.

- 2) What are the principles of stakeholder relationships in corporate governance?
- 3) State the functions of the following organs of corporate governance:
 - a) Board of directors
 - b) Audit committee
 - c) Risk management committee
4. State the provisions of the National Code of Corporate Governance on the place of external auditors in Corporate governance.

7.0 References/further reading

1. FRCN (2016).National Code of Corporate Governance for Private sector
2. ICAN(2009): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd

UNIT 6: INTERNAL CONTROL

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1.0 Introduction

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3.1 Definition of internal control

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1.0 INTRODUCTION

Auditors are expected to make a critical review of the internal controls system in existence in a client's establishment so as to ascertain the extent of examinations to be carried out in order to obtain sufficient appropriate evidence on which to base his conclusions and report. This unit discusses internal control systems, including controls in IT environment, the components of internal control, inherent limitations of controls as well as ways of recording internal control systems.

objectives

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

1. Explain internal control and discuss the components of internal control.
2. Discuss the General and application controls expected to be found in a computer- based environment
3. Discuss the inherent limitations of internal controls and the challenges of implementing effective control systems in small organizations
4. Demonstrate their understanding of the techniques auditors use in recording the assessment of a client's control risk/internal control system.

3,0 Main Content

3.1 Definition of internal control

Auditing Practices Committee defines internal control as "The whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise, in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records.

International Standards on Auditing (ISA 400) states that internal control system means all the policies and procedures adopted by the management of an entity to assist in achieving management's 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 fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information.

3.2 Objectives of internal control

Internal control is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls inter-relate. The above definitions establish four objectives of internal controls as:

- a) Promoting operational efficiency
- b) ensuring adherence to management policies
- c) safeguarding the assets of the organisation and
- d) to secure completeness and accuracy of the records, that is, ensuring the reliability of the financial statements

3.3 Scope/components of internal control

There are five components of internal control, namely –

- The control environment
- The entity's risk assessment process
- The information systems relevant to financial reporting
- Control activities and
- Monitoring of controls.

The Control Environment

The control environment is the framework within which controls operate. It includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance to the

entity.

While a strong control environment does not, by itself, ensure the effectiveness of the overall internal control system, it is a positive factor when assessing the risks of material misstatement. Management attitude towards control is a significant factor in determining how controls operate. Controls are more likely to operate well in an environment where they are considered important. The existence of internal audit function and budgetary system strengthen the control environment.

As part of understanding the control environment, **ISA 315** requires that the auditor evaluates whether:

- Management has created and maintained a culture of honesty and ethical behaviour
- The strengths in the control environment provide an appropriate foundation for the other components of internal control and whether those components are not undermined by deficiencies in the control environment.

When assessing the effectiveness of the control environment, the auditor should pay attention to the following elements of control environment:

1. Communication and enforcement of integrity and ethical values – these influence the effectiveness of the design, administration and monitoring of controls;
2. Commitment to competence – Management’s consideration of the competence levels for particular jobs and how such levels translate into requisite skills and knowledge;
3. Management’s philosophy and operating style – their approach to taking and managing business risks, attitudes and actions towards financing reporting as well as attitudes towards information processing and accounting functions and personnel;
4. Participation by those charged with governance – their independence from management, experience and stature, extent of involvement in control activities and scrutiny of activities and appropriateness of actions and interaction with internal and external auditors.
5. Organisational structure – The framework within which an entity’s activities are planned, executed, controlled and reviewed.
6. Assignment of authority and responsibility - how authority and responsibility for operating

activities are assigned and how reporting relationships and authorization hierarchies are established.

7. Human resource policies and practices – recruitment, orientation, training, evaluating, counseling, promoting, compensation and remedial actions.

The auditor assesses whether these elements of the control environment have been implemented using a combination of inquiries of management and observation and inspection.

SELF ASSESSMENT QUESTION

1. What is an internal control system?
2. What are the components of internal control system?

Entity's Risk Assessment Process

ISA 315 requires the auditor to obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives;
- Estimating the significance of the risks;
- Assessing the likelihood of their occurrence;
- Deciding upon actions to address those risks.

The auditor should note whether has established such a process or not, and discuss with management whether relevant business risks have been identified and how they have been addressed.

Information System relevant to Financial Reporting.

Information system relevant to financial reporting consists of the procedures and records to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity.

In respect of this component, the auditor looks into the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures by which those transactions are initiated, recorded, processed, corrected and reported in the financial statements.
- The related accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries used to record non-recurring, unusual transactions or adjustments.

The auditor should note how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.

Control Activities.

Control activities are those policies and procedures that help ensure that management directives are carried out. They include all activities designed to prevent or detect and correct errors. The elements or types of control activities include:

Segregation of duties: This requires that no one person initiates, authorizes, processes, records and maintains custody of assets arising from a transaction. That is, functions involved in a given transaction should be separated and carried out by different persons.

Physical controls: This concerns physical custody of assets and the design of procedures to limit access to authorized personnel only. It involves limiting direct access e.g. by locking up documents and other values in safes or warehouses or through the use of usernames and passwords and other

digital techniques to restrict access to computer files etc.

Authorisation and Approval: Every transaction should require authorization or approval by an appropriate person. Authorisation limits should also be specified.

Management controls: These include all supervisory controls by management over and above daily routine supervision, performance reviews, internal audit and other special review procedures.

Supervision: All the activities of staff should be supervised by appropriate line personnel. Responsibilities for supervision should be communicated to people concerned.

Organisation: There should be functional organization chart, defining lines of authority and responsibilities, including lines of reporting. The delegation of authority and responsibility should be clearly specified.

Arithmetical and Accounting controls: These involve ensuring that all transactions are authorized, completely captured, correctly recorded and accurately processed. Procedures include checking the arithmetical accuracy of the records, reconciliations, use of control accounts, sequence or continuity checks etc.

Personnel: Procedures should be designed to ensure that personnel have the appropriate skill sets, are competent, possess integrity and are motivated to carry out the tasks assigned to them. Systems are as good as the people operating them.

ISA 315 requires that the auditor obtains an understanding of control activities relevant to the audit and how the entity responds to risks arising from IT.

Monitoring of Controls

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.

The auditor should obtain an understanding of the major control activities that the entity uses to

monitor internal control over financial reporting, and how the entity initiates corrective actions to deficiencies in its controls. He should also understand the sources of information used in monitoring activities and the basis on which management considers it reliable.

3.4 THE ESSENTIAL FEATURES OF INTERNAL CONTROL

The detailed nature of the controls operative within any commercial organisation will depend upon:

- a) The nature and size of the business conducted
- b) The number of administrative staff employed
- c) The volume of transactions
- d) The materiality of transactions concerned
- e) The importance placed upon internal controls by the organisations own management
- f) The management style of the entity particularly the trust placed in the integrity and honesty of the key personnel and the latter's ability to supervise and control their own subordinate staff
- g) The geographical distribution of the enterprises and many other factors.

3.5 Limitations of Accounting and control systems

Internal control systems have inherent limitations which include:

- i. The possibility of controls being by-passed or overridden by management
- ii. Collusion between employees, rendering ineffective segregation of duties as a control measure
- iii. The potential for human error – the system is as effective as the personnel that implement it.
- iv. Controls may be designed to cope with routine and not non-routine transactions, that is, :

- the one-off or unusual transactions tend not to be the subject of internal control;
- v. The costs of controls not outweighing their benefits that is, a requirement that the cost of an internal control is not disproportionate to the potential loss which may result from its absence;
 - vi. changes in environment making controls inadequate

3.6 Problems of Internal control system in small companies

- It is not possible to achieve full segregation of duties in small companies as in large companies due to small complement of staff;
- This may lead top management to depend on close personal involvement in operations with little need to install formalised controls;
- This may also make them to override control and purposely exclude some transactions from accounting records;
- The auditor must therefore design an audit program which will be detailed enough to establish the accuracy and completeness of transaction;
- He will have to carry out detailed vouching and verification of assets and liabilities in the financial statements.

3.7 Recording Client's accounting and control systems

The techniques used in recording the assessment of a client's control risk/internal control system include:

Narratives: Narrative notes are used to describe and explain the control system, while also making any comments or criticisms that will demonstrate an understanding of the system. Narrative notes will highlight:

- The origin of every document and record in the system;
- All processing that take place
- The disposition of every document and record in the system and
- The indication of the controls relevant to the assessment of risk e.g. separation of duties, authorization and approvals and internal verification.

Advantages of Narrative notes

- i. They are relatively simple to record and can facilitate understanding by all engagement team members
- ii. The method is flexible and thus can be used for any system
- iii. Editing in future years can be relatively easy if they are computerized.

Disadvantages

- i. It is much more time consuming to describe systems in narrative than, say in a chart.
- ii. If written manually, updating will be untidy.
- iii. It can be difficult to identify missing internal controls because notes record the detail of systems but may not identify control exceptions clearly

Flowcharts

Flowcharts are graphic illustrations of the physical flow of information through the accounting system. Flowlines are used to represent the sequence of processes and other symbols represent the inputs and outputs to a process.

Advantages

- i. As information is presented in a standard form, they are fairly easy to follow and to review.
- ii. They generally ensure that the system is recorded in its entirety, as all document flows have to be traced from beginning to end. Any 'loose ends' will be apparent from a cursory examination.
- iii. They eliminate the need for extensive narrative and can be of considerable help in highlighting the salient points of control and any deficiencies in the system.
- iv. With a little practice/experience, flowcharts can quickly be prepared

Disadvantages

- i. Most suitable for describing standard systems. Procedures for dealing with unusual transactions will normally have to be recorded using narrative notes.
- ii. Major amendment is difficult without redrawing.

- iii. Time can be wasted by charting areas that are of no audit significance.

Internal Control Questionnaires (ICQs)

These are lists of questions designed to determine whether desirable controls are present for each major transaction cycle e.g. sales system, inventory system, purchases system, accounts receivable etc. There is usually one list of questions to cover each of the major transaction cycles. The questions are mostly designed in the form of YES or NO, while a NO answer indicates a deficiency in the system. For example, “are supplies examined on arrival as to quantity and quality? YES/NO/Comments

Internal Control evaluation Questionnaires (ICEQs)

ICEQs are designed to assess whether specific errors (or frauds) are possible. Thus, control questions that concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak, are asked. For example, some control questions for the purchases (expenditure) cycle could read:

Is there reasonable assurance that:

- a. all payments are properly authorized?
- b. All credits due from suppliers are received?
- c. All transactions are properly accounted for?
- d. Goods or services could not be received without a liability being recorded?
- e. Receipt of goods or services is required in order to establish a liability? etc

ICEQ questions can also be phrased to highlight a deficiency that should be prevented by a key control. In this case, a YES answer indicates a weakness. For example, “Can goods be sent to unauthorised suppliers?”

Advantages of ICQs and ICEQs

1. If drafted thoroughly, they can ensure all controls are considered.
2. They are quick to prepare
3. They are easy to use and control
4. ICEQs are drafted in terms of objectives; so they are easily applied to a variety of systems
5. Answers to ICEQs enable auditors to identify the key controls which they are most likely to test during control testing.
6. ICEQs can highlight deficiencies where extensive substantive testing will be required.

Disadvantages

1. When vaguely drafted, they are misunderstood and important controls may not be identified.
2. They may contain a large number of irrelevant controls.
3. The client may be able to overstate controls.

Checklists

These may be used in place of ICQs and ICEQs in the documentation and evaluation of internal controls. Statements made about control issues are ticked/marked off to indicate when the statement holds true. E.G., 'supplies are examined on arrival as to quantity and quality.'

Internal controls in a computerized environment

Controls in a computerized environment include both manual procedures and procedures designed into computer programmes. Two types of controls exist, namely *general controls* and *application controls*.

General IT controls

These consist of policies and procedures that support the effective functioning of application controls. They include controls over data centre and network operations, system software acquisition, access security, change and maintenance, application system acquisition, development and maintenance.

Examples of General controls

Development of Computer applications: Controls will include

1. Standards over systems design, programming and documentation
2. Full testing procedures using test data
3. Approval by computer users and management
4. Segregation of duties so that those responsible for design are not responsible for testing
5. Installation procedures so that data is not corrupted in transition

Prevention or detection of unauthorized changes to programmes: Controls will include

- 1 Segregation of duties
- 2 Full records of programme changes
- 3 Password protection of programmes to limit access to computer operations staff
- 4 Maintenance of programme logs
- 5 Back-up copies of programmes – stored in other locations
- 6 Virus checks etc

Testing and documentation of Programme changes:

1. Complete testing procedures
2. Documentation standards
3. Approval of changes by computer users and management
4. Training of staff using programmes

Controls to prevent unauthorized amendments to data files:

1. Password protection
2. Restriction of access to authorized users only

Controls to prevent wrong files being used

1. Libraries of programmes
2. Proper job scheduling
3. Operation controls over programmes.

Controls to ensure continuity of operations

1. Storing extra copies of programmes and data files off-site
2. Protection of equipment against fire and other hazards
3. Back-up power sources
4. Disaster recovery procedures e.g. back-up computer facilities
5. Maintenance agreements and insurance.

Application Controls

These are manual or automated procedures that operate at a business process level. They are designed to ensure the integrity of the accounting records. They relate to procedures used to initiate, record, process and report transactions or other financial data. The purpose of such controls is to ensure that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis.

Examples:

Control over input: Completeness

- Manual or programmed agreement of control totals
- Document counts
- One-for-one checking of processed output to source documents
- Programmed matching of input to expected input control file

Controls over input: accuracy

Programmes to check data fields on input transactions for plausibility

- Digit verification (e.g. reference numbers are as expected)
- Reasonableness check (e.g. VAT to total value)
- Existence check (e.g. customer name)
- Permitted range (no transaction processed over a certain range)
- Manual scrutiny of output and reconciliation to source.
- Agreement of control totals – manual or programmed.

Controls over input authorization

Manual checks to ensure information input was:

- Authorized
- Input by authorized personnel.

Controls over Processing

Ensures data processing has been done accurately without omissions or duplications. Similar controls as in input should exist e.g. batch reconciliations, control total reports etc. Screen warnings can prevent logging out before processing is complete.

Controls over master files and standing data

- Cyclical reviews of all master files and standing data
- Record counts (number of documents processed) and hash totals (e.g. the total of all the payroll numbers) used when master files are used to ensure no deletions
- Controls over the deletion of accounts that have no current balance.

Tests of Control

These are tests performed to obtain audit evidence about the effectiveness of the design of the accounting and internal control systems and the operation of the internal controls.

Tests of control include:

- Inspection of documents
- Inquiries about internal control e.g. who actually performs each function
- Re-performance of control procedures e.g. bank reconciliations
- Examination of evidence of management views e.g. minutes of management meeting,
- Observation of controls to consider the manner in which the control is being operated
- Tests over overall IT function e.g. access controls

Importance of internal controls to auditors

1. They prevent errors and frauds or material misstatement
2. They detect errors and frauds or material misstatement.
3. They ensure complete and adequate recording of transactions.

4. They ensure that all recorded transactions are valid, properly valued, related to the correct period, properly classified, correctly authorized and posted.
5. They help to ensure reliable financial reporting and compliance with relevant laws, regulations and standards.
6. They provide management with reasonable assurance that goals and objectives it believes important to the company, which is equally important to the auditor, will be met.

3.8 UNDERSTANDING THE INTERNAL CONTROL SYSTEM BY THE AUDITORS

In planning the audit, auditors should obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach. Understanding the accounting system will enable the auditor to identify and understand the major classes of transactions in the entity's operations, how such transactions are initiated, significant accounting records, supporting documents and accounts in the financial statements. It is important that the auditor understand the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements. By so doing he is able to appreciate the strength of the internal controls over these transaction cycles.

The factors affecting the nature, timing and extent of the procedures performed in order to understand the systems include:

- materiality considerations;
- the size and complexity of the entity
- their assessment of inherent risk
- the complexity of the entity's computer systems
- the type of internal controls involved, and
- the nature of the entity's documentation of specific transactions: The auditor updates previous knowledge of the accounting systems by making enquiries of appropriate supervisory and other personnel at various organizational levels within the entity, together with references to documentation such as procedure manuals, job descriptions and systems

descriptions.

- Inspection of relevant documents and records produced by the systems.
- Observation of the entity's activities and operations, including the information technology functions, organization, personnel performing control procedure and the nature of transactions processing.

4.0 Conclusion

Understanding a client's system of controls (either in a computer-based environment or not) is a good starting point for every audit. The correct assessment of the effectiveness of the internal control system helps the auditor in designing procedures geared towards ensuring that audited financial statements are largely free from material misstatements and enhancing the quality of the audit.

The techniques an auditor employs in recording the assessment of a client's control risk/internal control system include narratives, flow charts, ICQs, ICEQs and checklists. Each of these techniques has its advantages and disadvantages.

5.0 Summary

Internal control as a process enables an entity to achieve organizational objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. Every control system is designed to ensure the orderly and efficient conduct of business, safeguard the assets of the entity, prevent and detect fraud, ensure the completeness and accuracy of accounting records and the timely production of financial information. A complete system of internal control therefore should have the following five components namely: a good control environment, sound entity's risk assessment process, information systems relevant to financial reporting, functional control activities and effective monitoring system

6.0 Tutor marked Assignment

1. Define internal control and briefly explain the components of internal control.
2. Discuss the application controls necessary in a computer-based environment.

3. State 5 possible problems that may militate against the effectiveness of internal control system in a small business entity.

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UNIT 7: AUDIT PROGRAMMES AND AUDIT TESTING

Content

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Audit Programmes

3.2 Types of Audit Testing

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 INTRODUCTION

In this unit, we discuss the various types of audit programmes and the importance in the conduct of every audit. We also briefly explain the types of audit testing and when it is appropriate to use each type of test.

2.0 Unit objectives

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

1. Explain the concept “audit programme” and its usefulness in the audit process.
2. Discuss the different types of audit programmes and state the advantages and disadvantages.
3. Discuss the types of audit testing and their importance in the audit process.

3.0 Main Content

3.0 Audit Programmes

This is a detailed schedule of the audit work to be performed and the procedures to be followed in the verification of each item in the financial statements, including the estimated time period for each task. It gives the specific audit tests and procedures to be followed by the members of the audit team to enable them achieve the audit objectives. It is a guide to audit staff to keep to the audit plan so as not to derail from the audit objectives.

3.1.1 Types of audit programmes

There are five types of audit programmes namely: compliance, substantive, interim, year end and final audit programmes.

Compliance audit programme: These are audit programmes designed to obtain audit evidence as to whether internal controls systems are being complied with by the management both in theory and in practice;

Substantive audit programmes: Audit programmes which contain tests and procedures to obtain audit evidence as to the completeness, accuracy and validity of transactions as well as obtaining evidence on the cost, authorisation, valuation, existence, beneficial ownership and presentation of assets and liabilities in the financial statement;

Interim audit programme: This contains procedures to be performed during interim audit visit.

Though some aspect of substantive procedures will be included, the programme relate mainly to those performed in systems audits;

Year end audit programme: These are procedures to be executed at the year-end audit visit. Like the ones undertaken during the year-end inventory and cash counts; and

Final audit programmes: These are programmes containing audit procedures to be performed during the final audit visit. Though some aspect of compliance procedures will be included, it mainly relate to those performed in connection with the transactions and Statement of financial position audit and the review of financial statements.

Audit programmes may also be described as fixed or flexible audit programmes.

Fixed Audit Programme: Programmes that remain unchanged the course of audit assignment. The use of such programme is not encouraged as the auditor could be put on inquiry at any point in time and that may necessitate a change in planned procedures. The engagement staff should be encouraged to apply “original thought” to the engagement.

Advantages of Fixed Audit Program

- Fixed audit programmes are prepared once and programme is used in all the organization. So, it saves time and cost.
- All the works are completed within the stipulated time because auditor does not change such programme on the request of assistant staff.
- Audit programme fixes the responsibility of assistant staff. So, they know their responsibility and complete their work in time which helps to prepare and present report in time.

Disadvantages of Fixed Audit Program

- Such programme is rigid. So, it cannot be used in all organizations because nature and size of all the businesses do not remain same.
- The same programme will not be useful in the big and small organizations.
- Fixed audit programme is unscientific and impracticable because it does not incorporate

the changes caused by time and situation.

- Fixed audit programme does not permit intelligent staff to think outside of the box and exercise their skill and knowledge.

Flexible Audit Program

An audit programme which can be changed as per the need, time, nature of business and auditing standard is known as flexible audit programme. Such programme should be reviewed on the recommendations and suggestions of assistants. Such change can be made due to change in number of work, nature of business, change in management and their feelings. Flexible programmes only act as guide to engagement staff. They can review it based on situations on ground in client's office.

Advantages of Flexible Audit Program

- Auditing remains effective because programme responds to circumstances and emerging events.
- Staff are happy as they are allowed to take initiatives and respond appropriately when put on inquiry.

3.1.2 Advantages and Disadvantages of Audit Programmes

Advantages of an Audit Programme

1. It serves as a basic instrument for training the audit staff;
2. It helps in orderly execution of audit work as it provides a clear set of instructions on the work to be carried out.
3. It serves as a reference for reviewing future audit planning efforts.
4. It provides a clear record of work done and by whom.
5. No important work will be overlooked or any work duplicated.
6. Evidence of work done is available for use in defending any actions for negligence etc.

Disadvantages of an Audit Programme

1. Work may become mechanical; initiative may be stifled.
2. Programmes are rigidly adhered to, though client systems may have changed.
3. A fixed audit programme and limited time tend to inhibit further probing when the

auditor's suspicion is aroused.

3.2 TYPES OF AUDIT TESTING

i) Compliance test

These are tests which seek to provide audit evidence that internal control procedures are being applied as prescribed. They are tests to obtain audit evidence about the effective operation of the control environment and in particular, the operation of the control procedures.

In compliance tests, the auditor tests the application of the control procedure and not the transaction itself, though the testing is through the medium of the transaction. For example, suppose that a system provides that all credit notes issued by a company must be approved by the sales manager. To test whether the control operates as prescribed, the auditor will inspect a sample of credit notes to see if they have been approved/initialed by the sales manager. The details of the credit note e.g. coding, calculations etc are not relevant to the test being performed.

In the test of controls, the auditor looks at the 5 components of an entity's internal control viz.

- i. The control environment – the control culture of the entity and its impact.
- ii. The entity's own risk assessment process – how the entity identifies, assesses and responds to its business risks.
- iii. Information systems relevant to financial reporting – those systems related to the capture of significant transactions, events or accounting activities, data entry of transactions etc.
- iv. Control activities relevant to audit – those policies and procedures that help ensure that management directives are carried out (i.e control activities designed to prevent/detect misstatements) e.g controls on authorization, performance reviews, information processing, physical controls and segregation of duties.
- v. Monitoring control activities – activities that entity uses to monitor control activities over financial reporting as well as how it takes actions to address any identified deficiencies.

Where from preliminary review of the system of controls, the system appears weak or defective, the auditor may need to abandon the systems approach and apply substantive testing/approach.

.ii. Walk through tests

Walk through tests are defined as tracing one or more transactions through the accounting system

and observing the application of relevant aspects of the internal control system. For example the auditor might look at the sales system in a wholesaler and trace a sale from initial through to the sales figure in the profit and loss account. This will involve looking at customers' orders, how the orders are documented and recorded, credit control approval, how the goods are selected and packed, raising of an advice note and /or delivery note, invoicing procedures, recording the invoice in the book of account and so on. At each stage the control applied are examined. Walk through tests is used by the auditor to enable him have an understanding of a client's accounting system and control environment from this initial understanding; it is possible to plan the audit and determine the audit approach.

iii. Substantive test

Substantive tests are those tests of transactions and balances and other procedures such as analytical reviews, which seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or the financial statements. All tests other than tests of control are substantive tests. Thus, substantive test is any test which seeks direct evidence of the correct treatment of a transaction, a balance, an asset, a liability or any item in the books of account. Substantive tests are designed to obtain audit evidence to detect material misstatements in financial statements.

Methods of obtaining audit evidence include the following:-

- a) Inspection – This refers to the review or the examination of records, documents or tangible assets. Inspection of records and documents provide evidence of varying degrees of reliability depending upon their nature and source. The inspection of tangible assets provides the auditor with reliable audit evidence as to the existence of those assets but not necessarily as to their ownership, cost or value.
- b) Observation: This is looking at an operation or procedure being performed by others with a view to determining the manner of its performance. Observation provides reliability as to the manner of doing the job at the time of observation, but not at any other time.
- c) Enquiry: The enquiry is seeking relevant information from knowledgeable persons inside or outside the enterprise whether formally or informally, orally or in writing. The degree of reliability that the auditor attached to evidence obtained in this manner is dependent on his opinion of the

competence, experience, independence and integrity of the respondent.

d) Computation: Checking the arithmetical accuracy of accounting records or performing independent calculations.

e) Analytical Review: These procedures include studying significant ratios, trends and other statistics and investigating any unusual or unexpected variations. The precise nature of these procedures and the manner in which they are documented will depend on the circumstances of each unit. The comparison which can be made will depend on the nature, accessibility and relevance of the data available.

4.0 Conclusion

Audit programmes guide engagement staff on procedures, timing and nature of tests to carry out during the audit process. Though there are many advantages of using audit programmes, it also has its limitations such as stifling the initiative of staff.

Audit tests usually conducted include tests of control (compliance tests), substantive tests and walk through tests.

5.0 Summary

Audit programme is a detailed work plan which includes the time of doing work and how to do the works. It thus includes audit procedures to be performed and the timing of such activities. Audit programmes act as guide to audit testing which could be compliance tests (for tests of controls), or substantive tests to establish the completeness, validity and accuracy of transactions.

6.0 Tutor marked assignment

1. What is an Audit Programme and how does it enhance audit assignment and audit process?
2. What are the types of Audit programmes and what disadvantages do they have inherent in them?
3. Distinguish between compliance tests and substantive tests.

4. State the advantages and disadvantages of audit programmes.

7.0 References/Further reading

1. Adeniji, A.A (2012). Auditing and Assurance Services. Lagos: Value Analysis Consults.
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UNIT 8 INTERNAL AUDIT AND OUTSOURCING

Content

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3.8 Outsourcing the internal audit functions

4.0 Conclusion

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6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 Introduction

The focus of this unit is on internal audit and its possible outsourcing. The unit looks at the need for internal audit function, its functions, types of assignments and the differences between internal audit function and external audit. The unit also examines the need for outsourcing of IA function.

2.0 Unit Objectives

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

1. Describe the functions of internal audit and differentiate between internal and external audits
2. Explain the following types of audits: financial, operational and compliance audits
3. Discuss the relative advantages and disadvantages of outsourcing internal audit function.

3.0 Main Content

3.1 Definition of concept

The Institute of Internal Auditors (IIA) defines internal auditing as “an independent appraisal function established within an organization to examine and evaluate its activities, as a service to the organization.” It is described as an independent, objective assurance and consulting activity designed to add value and improve the operations of an organization. It adopts a systematic, disciplined approach in evaluating and improving the effectiveness of risk management, control and governance processes and thus helps an entity to achieve its objectives.

Internal audit is an important organ of the governance structure in any organization that reviews the accounting and internal control systems and plays a vital role in risk management.

3.2 Reasons for the development of internal auditing

- i. Internal audit helps management to monitor the controls within their entity. As entities increase in size and complexity, the task of monitoring controls becomes more difficult.
- ii. An internal audit function can be used to monitor the effectiveness and efficiency of operations.
- iii. An internal audit function can be used by management to monitor the entity's compliance with laws and regulations.
- iv. For entities that use complex IT systems, specialist internal auditors can help management to review the effectiveness of controls within IT systems.
- v. The IA function helps in reducing the cost of external audits, especially where the internal auditor conducts financial audits. It can also be used to carry out other non-audit services that may otherwise be contracted to external audit firms.

3.3 Functions of internal audit

Typical functions of an internal audit function include:

1. *Monitoring of internal control.* Management usually assigns the responsibility for reviewing controls, monitoring their operation and recommending improvements to the internal audit department.
2. *Examination of financial and operating information.* An internal audit department might be given the responsibility for a detailed examination of financial and operating information, and in particular, its reliability and usefulness.
3. *Review of the economy, efficiency and effectiveness of operations,* including non-financial controls of an entity. Audits of economy, efficiency and effectiveness can be carried out on any aspect of operations, and are usually called value for money (VFM) audits.
4. *Review of compliance.* Through 'compliance audits', the internal auditors check that operational departments are complying properly with certain laws, regulations and other

external requirements, or with management policies and directives and other internal requirements.

3.4 Differences between Internal Audit and External Audit

	INTERNAL AUDITORS	EXTERNAL AUDITORS
Appointment	Employed by management	Employed by members at AGM
Audit scope	Defined by company management	Defined by the statutes and other relevant regulations
Audit objectives	To ensure completeness, accuracy and validity of company's transaction in the financial records	To ensure that information in the financial records as presented in the financial statements give a true and fair view.
Duties	Determined by the management	As laid down by the statute or as per letter of engagement
Independence	Not strictly independent as they are employees of the company	Strictly independent of the company's management as they report to members at the annual general meetings
Reporting status	To the management	To the shareholders
Qualification	May or may not be a qualified accountant	must be a qualified and licensed accountant
Requirement	Discretionary (Not mandatory)	Statutorily required(mandatory)

3.5 Types of internal audit assignments

Financial audits: This is the traditional role of the internal auditor. The IA department reviews accounting and other records to validate figures appearing in financial statements and management accounts. This work is currently seen as a minor part of the work of the internal auditor as it overlaps with the work of the external auditor. However, financial audits help the internal auditor to assess and monitor the strength and effectiveness of the internal controls with a view to recommend improvements if there are identified weakness in the system.

Operational audits: Operational audits examine the entity's internal control procedures and whether or not the control systems that have been established by management are operating effectively. Value for money (or VFM) audit is a form of operational audit. VFM audits strive to find the best possible combination of the 3Es (effectiveness, economy and efficiency) that will maximise profit performance. Thus, one of the purposes of a VFM audit should be to check whether the most appropriate balance between economy, efficiency and effectiveness is being achieved.

Compliance audits: Entities are subject to a number of laws and regulations, that may expose them to the risk of regulatory action by the authorities if they fail to comply with the regulations. Some of these laws and regulations include Health and hygiene controls for the food manufacturing industry, environmental pollution for companies involved in oil and gas exploration, controls over money laundering for financial services; and controls over safety for companies in the public transport industry. Internal audit is used to monitor compliance with these laws and regulations.

Other assignments that are carried out by the IA function include

social audits: these are checks on the impact of the entity on the society in which it operates; **environmental audits:** these are checks on the effect the entity is having on its natural environment, and considers issues such as the use of sustainable materials, re-cycling, reducing pollution, and so on; and

human resource audits: these are audits into the work force of an entity, to check whether the entity has adequate systems for the recruitment, training and development of employees to meet its current and future needs.

3.6 Internal audit reports

Internal auditors typically issue reports at the end of each audit that summarize their findings, recommendations, and any responses or action plans from management. An audit report may have an executive summary; a body that includes the specific issues or findings identified and related

recommendations or action plans; and appendix information such as detailed graphs and charts or process information. Each audit finding within the body of the report may contain five elements, sometimes called the "5 C's":

Condition: What is the particular problem identified?

Criteria: What is the standard that was not met? The standard may be a company policy or other benchmark.

Cause: Why did the problem occur?

Consequence: What is the risk/negative outcome (or opportunity foregone) because of the finding?

Corrective action: What should management do about the finding? What have they agreed to do and by when?

The recommendations in an internal audit report are designed to help the organization achieve effective and efficient governance, risk and control processes associated with operations objectives, financial and management reporting objectives; and legal/regulatory compliance objectives.

3.7 Qualities of good Internal Audit Report

Objectivity - The comments and opinions expressed in the report should be objective and unbiased.

Clarity: The language used should be simple and straightforward.

Accuracy: The information contained in the report should be accurate.

Brevity: The report should be concise.

Timeliness: The report should be released promptly immediately after the audit is concluded to enable management take remedial action. In some urgent matters and serious breaches, an interim report could be issued before the assignment is concluded.

3.8 Outsourcing the internal audit functions

Some entities outsource the work of the internal audit function. When this happens, the service provider is often the accountancy firm that provides the entity with its external audit services.

3.8.1 Advantages of outsourcing internal audit functions.

- i. An external service provider may have skills and expertise for doing the work, that the entity itself does not have 'in house'. The accounting firm may likely have access to more highly trained, specialist employees.
- ii. Access to the most up-to-date techniques and technology might not be readily available within the entity, but the external audit firm may have them.
- iii. The management of the entity are able to focus their time and effort on 'core activities', and do not have to spend as much time monitoring the outsourced activities.
- iv. The accounting firm is likely to have a greater level of independence than the entity's own internal audit staff.
- v. The accounting firm will have greater numbers of employees available for any urgent internal audit assignments.
- vi. Professional codes of conduct and standards of behaviour will regulate the accounting firm. This might not be the case with an in-house internal audit department.
- vii. The accounting firm may be sued for breach of contract or for negligent work and thus, more likely to pursue the assignment with greater care and diligence.

3.8.2 Disadvantages of outsourcing the internal audit function.

- i. Professional firms are not under the control of the entity in the same way as their 'in house' internal audit employees.
- ii. Fees for internal audit work can be high.
- iii. Professional firms may not have the same level of detailed knowledge of the entity and its operations that 'in house' internal auditors (working in the organisation on a daily basis) should have.
- iv. There may be threats to the independence of the external audit where the firm acts as both internal auditors and external auditors.

3.8.3 Control Measures for Managing Outsourced internal audit

1. Set performance measures and investing variance.
2. Ensure appropriate audit methodology is maintained.
3. Review working papers to ensure they meet internal auditing standard/guidelines.
4. Agree with Internal audit work plan in advance.
5. If same external auditor is used, ensure that the firm has a sound internal control to separate the two functions to further enhance independence and objectivity.

4.0 Conclusion: The IA function is an important organ of the corporate governance structure that is concerned with reviewing the financial and administrative controls of the entity as well as the efficiency of operations and compliance with policies, laws and regulations. Depending on the size, capacity and operational complexity of an entity, this function can be outsourced to an external accounting firm but the entity may need to consider the cost-benefit outcome before taking such decision.

5.0 Summary: In this unit, we examined the role of the internal audit function as part of corporate governance. The functions of the IA function, namely, monitoring of internal control, examination of financial and operational information, review of the economy, effectiveness and efficiency of operations and compliance monitoring, were discussed. The unit also examined the differences between the IA function and external audit, types of internal audit assignments – financial audit, operational audit and compliance audit as well as the outsourcing of IA function.

6.0 Tutor marked assignments

1. Define internal audit and explain the functions of an internal audit function.
2. Some entities outsource the work of the internal audit function to external audit firms. Discuss the factors an entity may consider before outsourcing its internal audit function. What are the possible disadvantages of outsourcing of the IA function.
3. Explain the following types of audits: financial audit, compliance audit and operational audit.

7.0 References/further reading

1. ICAN(2014). Audit and Assurance Study text. UK: Emile Woolf International
2. Olowookere, K. (2007). Fundamentals of Auditing. Ibadan: Silicon Publishing Company.
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UNIT 9: VERIFICATION OF ASSETS AND LIABILITIES

Content

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Verification of Assets

3.2 Liability Verification

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 Introduction

In the auditing standard, it is expected of the auditor to ascertain the existence of the company's assets and liabilities at a reporting date. This would enable the auditor to be able to form an opinion on the true and fair view of the financial statements as at the reporting date. The auditor has a duty to verify all the assets and liabilities appearing in the statement of financial position as well as to ensure that there are no omissions of assets and liabilities which ought to appear in the statement of financial position.

2.0 Objectives

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

1. Explain the audit objectives for the verification of assets and liabilities.
2. Describe the general procedures for the verification of assets and liabilities.
3. Give audit procedures and tests applicable to the verification of specific assets and liabilities.

3.0 Main Content

3.1 VERIFICATION OF ASSETS

In assets verification, the auditor seeks to establish the following:

- 1) Cost: This is the amount paid or fair consideration given at the time of acquisition/purchase. Inspection of title deeds, invoices and other documents will assist in this regard.
- 2) Authorisation: This confirms the due process followed in acquiring the asset. Authorisation from the appropriate level of management is necessary. Inspection of minutes of board and/or management meetings is important.
- 3) Valuation: It is important that the carrying amounts of the assets in the books is appropriate – no

over-valuation or under-valuation. Where technical knowledge is required, the auditor may rely on the information/report provided by an expert in the area.

4) Existence: The auditor needs to confirm the physical existence of the item through physical inspection – counting, measurement or other documentary evidence duly signed by a responsible official of the company.

5) Beneficial ownership: That an asset exists does not confirm beneficial ownership. The Auditor needs to sight title deeds, certificates of ownership, invoices and other evidences that confer ownership of the asset on the client company.

6) Presentation and disclosure: The auditor seeks to satisfy himself that the assets have been properly classified and fairly presented and disclosed in accordance with the requirements of the reporting framework.

These aspects can be remembered by the mnemonic CAVEBOP.

3.1.1 Audit/Verification of Property, Plant and Equipment (Tangible Non-current assets)

The verification of PPE(non-current assets) will often commence with an examination of asset registers. One main use of asset registers to the auditor is to facilitate the identification of assets during a physical check. They also form an important part of the system of internal control. The register must be agreed with the financial records and enquiries as to the extent and frequency of checks by company officials on the reconciliation of financial records, assets register and physical assets.

PPE carried in the books in any reporting period may be newly acquired or brought forward from the previous year. There is need to verify the cost of, and authorization for, the newly bought assets, but no such need exists for the ones brought forward from previous reporting period as that procedure was carried out in the year of acquisition.

Procedure followed for the verification of PPE are:

- Assess and document the internal controls over PPE in order to determine the level of reliance to be placed on them.
- Obtain client's schedule of each class of PPE, giving the movement on each class of assets within the period as follows:
 - ✓ Opening balance brought forward from previous year;
 - ✓ Acquisitions within the year;
 - ✓ Disposals within the year;
 - ✓ Depreciation, amortization and other write downs.
- Carry out physical inspection to confirm existence.
- Inspect title deeds, invoices and certificates of ownership to confirm ownership and costs for new acquisitions.
- Check that appropriate accounting policies are adopted and consistently applied and that adequate disclosures are made.
- Obtain a letter of representation from management.

3.1.2 Audit of intangible Non- current assets

The types of assets we are likely to encounter under this heading include goodwill, patents, trademarks, copyrights etc. According to IAS 38 *Intangible assets*, intangible assets can either have finite or infinite life. Intangible assets with finite life should be systematically amortized with a depreciation method that best shows how the assets is being utilized while intangible assets with infinite life should be tested for impairment. The following special points may provide a brief but useful summary of documents to be examined and procedures to be observed in relation to these types of assets.

Goodwill

- Agree the consideration to sales agreement by **inspection**.
- Consider the reasonableness of asset valuation;
- Perform some recalculation and agree that the calculation is correct.
- Review the entity's impairment review and discuss with management
- Following your discussion with management, ensure valuation of goodwill is reasonable and that there is no impairment not adjusted.

Research and development costs

- Confirm that capitalized development costs conform to IAS 38 criteria by inspecting details of projects and discussions with technical managers.
- Confirm feasibility and viability by inspection of budgets
- Recalculate amortization calculation to ensure it commences with production and is reasonable
- Inspect invoices to verify expenditure incurred on R & D projects.

Other intangible assets

- Agree purchased intangibles to purchase documentation agreement by **inspection**.
- Inspect specialist valuation of intangibles and ensure it is reasonable.
- Inspect certificates/assignments issued by appropriate offices/agencies, where applicable
- For trademarks, check compliance with terms as to payment of royalties

- Confirm payment of renewal fees, where applicable
- Review amortization calculations and ensure they are correct by **recalculation**.

3.1.3 Verification of stocks and work in progress

It is the responsibility of the management of an entity to ensure that the amount at which stocks are shown in the financial statements represents stocks physically in existence and includes all stocks owned by the entity, while the auditor has a duty to obtain necessary evidence to satisfy himself as to the ownership, existence and condition of stocks valued at the year end. Auditors pay particular attention to audit of stocks and W.I.P. because:

- stocks usually constitute one of the largest items in the statement of financial position, hence a relative small error in stock will have a material effect on the financial statements.
- Closing stock affects cost of sales and therefore profit or loss directly
- Stocks could be manipulated to achieve a targeted profit level
- Different accounting bases are used in the valuation of stock
- There may be problem of valuation, determination of the existence and stages of development of some specialised stocks in livestock, production products etc.

Objectives of stock taking

- i. To verify the condition of stock
- ii. To verify the existence of stocks
- iii. To establish title of stock
- iv. To determine the accuracy of cut-off
- v. To ascertain the effectiveness of internal control system over stock
- vi. To provide a basis for checking the correctness of stock records
- vii. To ensure that adequate provision has been made for slow moving and obsolete stocks
- viii. To provide a basis for the quantity required for the valuation of stocks
- ix. To determine the accuracy of stock valuation

Auditor's duties before, during and after stock taking

ISA 501 *Audit Evidence – special consideration for selected items* directs that where inventory is material, the auditor shall obtain sufficient appropriate evidence regarding its existence and condition by attending the physical inventory count (unless this is impracticable) to do the following:

- Evaluate management's instructions and procedures for recording and controlling the result of the physical inventory count
- Observe the performance of the count procedures
- Inspect the inventory and

- Perform test counts.

The auditor also performs audit procedures over the entity's final inventory records to determine whether they accurately reflect the count results. In this regard, the auditor will;

- Trace items that were test counted to final inventory sheets.
- Observe whether all count records have been included in final inventory sheets
- Inspect all final inventory sheets to ensure they are supported by count records
- Ensure that continuous inventory records have been adjusted to the amounts physically counted or measured, and that differences have been investigated
- Confirm cut-off by using details of the last serial number of goods inwards and outwards notes and details of movements during the count.
- Review replies from third parties about inventory held by or for them
- Confirm the client's final valuation of inventory has been calculated correctly
- Follow up queries and notify problems to management.

3.1.4 Verification of trade debtors

Debtors may constitute a material amount in the statement of financial position. The auditor will need to ensure existence, ownership and valuation of the amount. Thus, procedures are geared towards getting reasonable assurance that:

- The debtors represent real amount due to the company; and
- Adequate provision has been made for bad and doubtful debts, discounts and returns.

Verification Procedure

- Determine the system of internal control over sales and debtors. The system should ensure that:
 - ✓ Only bon fide sales bring debtors into existence
 - ✓ All sales are to approved customers

- ✓ Once recorded, the debts are only eliminated by receipt of cash or on the authority of a responsible official
 - ✓ Debts are collected promptly and balances are regularly reviewed and aged
 - ✓ A proper system for follow up exists and adequate provision for bad and doubtful debts is made, where necessary.
-
- Obtain a schedule of debtors
 - Test cast the schedule
 - Agree the schedule to individual ledgers and the general ledger
 - Review age-analysis of debts
 - Ensure that adequate provision is made for bad and doubtful debts
 - Carry out positive circularization of material debtors
 - Trace payments by customers on sample basis to individual debtor's accounts to ensure accuracy of recording
 - Ensure adequacy of sales cut-off
 - Ensure appropriate disclosure requirements are met
 - Request for a letter of representation.

Circularisation of debtors

Auditors circularise a carefully selected sample of the company's debtors as means of:

- ensuring the accuracy of book entries in the sales ledger and the resulting balances
- ensuring the proper functioning of the system of credit control as laid down by the directors
- identifying accounts in dispute and

- ensuring that records concerned are completely up to date.

The objectives of circularization, therefore are:

- i. To test the effectiveness of control on sales incomes, recording and banking.
- ii. To test the adequacy of provision made for bad and doubtful debts and
- iii. To ensure completeness, accuracy and validity of records.

Circularisation takes two forms:

- the negative circular, which requires a reply only if the debtor disputes the balance shown on the form; and
- the positive circular, which requests in every case confirmation of details of sums shown as outstanding in the records of the debtor.

The negative method is simpler and requires no follow up. The usefulness of the positive method, by contrast, depends largely upon the auditor's tenacity in following up the non-replies, by telephone or even personal call if necessary. It is essential that replies be sent to the auditor directly at his own office, otherwise there is a risk of tampering or suppression by client staff

3.2 LIABILITY VERIFICATION

A statement of financial position will contain many liabilities grouped under various headings. The heading may include

- a) Share capital
- b) Reserves
- c) Non-current liabilities
- d) Current liabilities

e) Contingent liabilities (among the notes to the accounts)

The auditor's duty is to

- Verify the existence of liabilities shown in the balance sheet
- Verify the correctness of the money amount of such liabilities
- Verify the appropriateness of the description given in the accounts and the adequacy of disclosure
- Verify that all existing liabilities are actually included in the accounts

Verification procedures

It is not possible to detail the procedures for verifying all possible liabilities. However, some general principles can be discerned and these should be applied according to the particular set of circumstances met within practice or in an examination.

Some of them are: -

Schedule: Request or make a schedule for each liability or a class of liabilities.

Cut-off: Verify cut-off. For example a trade creditor should not be included unless the goods were acquired before the year end

Reasonableness: Consider reasonableness of the liability - *Internal control:* Determine, evaluate and test internal control procedures

Previous date clearance: Consider the liabilities at the previous accounting date. Have they all been cleared?

Authority: The authority for all liabilities should be sought

Description: Ensure that the description in the accounts of each liability is adequate

Documents: Examine all relevant documents. These will include invoices, correspondence, debenture and deeds etc according to the type of liability

Vouching: The creation of each liability should be vouched, e.g. receipt of a loan –

Accounting policies: The auditor must satisfy himself that appropriate accounting policies have been adopted and applied consistently. –

Disclosure: All matters which need to be known to receive a true and fair view must be disclosed -

External verification: With many liabilities, it is possible to verify the liability directly with the creditors.

Materiality: Materiality comes into all accounting and auditing decisions. By their nature and size, will they have material effect on the financial statements if misstated?

Post-period(subsequent) event: Very important in this area than in any other. Contingent liabilities may crystallise after the reporting date (an adjusting event).

Accounting standards: Liabilities must be accounted for in accordance with the relevant accounting and auditing standards

Risk: Assess the risk of misstatement.

4.0 Conclusion: Assets and liabilities define the financial position of an entity and thus require good audit attention. The auditor therefore carries out procedures to get reasonable assurance on their cost, existence or occurrence, beneficial ownership, authorization, proper valuation, and presentation and disclosure in the financial statements.

5.0 Summary: The unit discussed the audit objectives for the verification of assets and liabilities. It further highlighted audit procedures for verifying tangible non-current assets, intangible non-current assets, inventory, debtors and liabilities.

6.0 Tutor marked assignments

1. Discuss the audit objectives for the verification of assets and liabilities.
2. What are general procedures in verification of liabilities?
3. Discuss the audit procedures for the verification of tangible non-current assets.

7.0 References/Further reading

1. ACCA (2015): Audit and Assurance Study text, London: Emile Woolf International
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UNIT 10: AUDIT REPORT

Content

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Scope

3.2 Elements/Format of an Auditor's Report

3.3 Content of Auditor's Report (Summary of matters to be expressly stated in the auditor's report): Schedule 6, CAMA, Cap C20. LFN 2004

3.4 Isa 705 Modifications to the Opinion in the Independent Auditor's Report

3.5 Internal Audit Reports

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/further Reading

1.0 Introduction

This unit discusses extensively what an audit report is, the types and the International Audit Standards (ISAs) that relate to it.

2.0 Objectives

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

1. Describe the financial statement evaluation process that guides the forming of auditor's opinion on a set of financial statements

2. Discuss the elements of an independent auditor's report in accordance with ISA 700 (revised).
3. Explain the types of modification of independent auditor's report as stipulated by ISA 705.
4. Explain a letter of weakness and its usefulness in the audit process.

3.0 Main Content

3.1 Scope

ISA 700 'Forming an Opinion and Reporting on Financial Statements' deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

ISA 705 and ISA 706 deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter or an Other Matter paragraph in the auditor's report.

ISA 700 'Forming an Opinion and Reporting on Financial Statements

An unmodified opinion (also sometimes called unqualified opinion) is expressed when the auditor concludes that the financial statements (FS) give a true and fair view (or are presented fairly in all material respect) in accordance with the applicable financial reporting framework.

If the auditor:

- a) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free material misstatement or
- b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with **ISA 705**.

In order to form an opinion, the auditor shall evaluate and conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That evaluation and conclusion shall take into account:

1. The auditor's conclusion whether sufficient appropriate audit evidence has been obtained
2. The auditor's conclusion whether uncorrected misstatements are material, individually or in aggregate.
3. The financial statements adequately disclose the significant accounting policies selected and applied
4. The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate.
5. The accounting estimated made by management are reasonable
6. The information presented in the financial statements is relevant, reliable, comparable and understandable
7. The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
8. The terminology used in the financial statements, including the title of each financial statements, is appropriate,
9. The overall presentation, structure and content of the financial statements
10. Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation

10.2.1The Basis and Elements of Auditor's Report (Effective from December 15, 2016)

Companies and Allied Matters Act CAP C20 LFN 2004, gives the legal requirements as to content of the auditor's report but not the format. But ISA 700 provides details of the basis and elements/format of the auditor's report for audits conducted in accordance with International standards on Auditing.

ELEMENTS/FORMAT OF AN AUDITOR'S REPORT

1 Title

This should clearly indicate that it is an independent auditor's report- 'Independent Auditor's Report'

2 Addressee

The enabling law, regulation and circumstances of the engagement determine the addressee and specify this. In Nigeria, the independent auditors for audit of companies is addressed to members of the companies.

3. Auditor's Opinion

This shall have the heading 'Opinion'

The Opinion section of the auditor's report shall:

- a) Identify the entity whose financial statements have been audited
- b) State that the financial statements have been audited
- c) Identify the title of each statement comprising the financial statements
- d) Refer to the summary of significant accounting policies and other explanatory notes
- e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

An unmodified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly in all material respects, in accordance with the applicable framework

4. Basis for Opinion

This section:

- A) States that the audit was conducted in accordance with International Standards on Auditing (ISA).
- B) Refers to the section of the auditor's that describes the auditor's responsibilities under the ISA's.
- C) States whether the auditor believes that the audit evidence is sufficient and appropriate to provide a basis for the auditor's opinion.

5. GOING CONCERN

Where applicable, the auditor shall report in accordance with ISA 570 (Revised): Where the auditor agrees with the management's use of going concern basis, and there is a material uncertainty which may cast a significant doubt on the going concern basis and which has been adequately disclosed, the auditor should issue an unmodified report. He should however, add a separate section under the heading 'Material Uncertainty Related to Going Concern' to draw attention to the note in the financial statements that discloses the matters concerning the material uncertainty.

6. Key Audit Matters

The auditor is required to communicate key audit matters in the auditor's report in accordance with ISA 701. Communicating key audit matters (KAM) enhances the communicative value of the auditor's report by providing greater transparency about the audit that was performed. KAM assists users understand those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period e.g areas of higher assessed risk of material misstatement, or significant risks; significant auditor judgments relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty as well as

effect on the audit of significant events or transactions that occurred during the period.

However, where an auditor disclaims an opinion on a set of financial statements, KAM shall not be communicated.

7. Management's Responsibilities for the financial Statements

The report should state that the management is responsible for the preparation and fair presentation of the financial statements in accordance with the provisions of CAMA.

Management's responsibilities includes

1. Designing, implementing and maintaining the internal control system relevant to the preparation and fair presentation of financial statements that are free from material misstatements whether due to error or fraud.
2. Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing. If applicable, matters relating to going concern.

The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

8. Auditor's Responsibility for the Audit of the Financial Statements

The auditor's report shall:

- A) State that the objectives of the auditor are to:
 - i) Obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

- ii) Issue an auditor's report that includes the auditor's opinion.
-
- B) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatements when it exists; and
 - C) State that misstatements can arise from fraud or error, and either:
 - i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
 - ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework
 - D) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional scepticism throughout the audit; and
 - E) Describe an audit by stating that the auditor's responsibilities are:
 - i) To identify and assess the risks of material misstatement of the financial statements. Whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion.
 - ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the expressing an opinion on the effectiveness of the entity's internal control.

NOTE: In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of financial statements, the audit shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control'

- iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

NOTE: If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

- v) When the financial statements are prepared in accordance with a fair

presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- F) When ISA 600 (Group Audit) applies, further describe the auditor's

responsibilities in a group engagement by stating that:

- i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;
- ii) The auditor is responsible for the direction, supervision and performance of the group audit; and

iii) The auditor remains solely responsible for the auditor's opinion.

- G) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- H) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence and where applicable related safeguards; and
- I) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with ISA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

NOTE: The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

9. OTHER REPORTING RESPONSIBILITIES

Laws, standards or generally accepted practice may require or permit an auditor to report on other matters that provide further explanation of the auditor's responsibility. Such matters may be addressed in a separate paragraph following the auditor's responsibility. Such matters may be addressed in a separate paragraph following the auditor's opinion e.g compliance with CBN regulations or the requirements of the Insurance Act or even the legal requirements on content of

auditor's report as stipulated by schedule 6, CAMA, Cap C20, LFN 2004.

This section shall be titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of this section

10. Name of the Engagement Partner

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosures are reasonably expected to lead to a significant personal security threat, the severity of which has to be discussed and agreed with those charged with governance.

11. Auditor's Signature

The report is signed by the engagement partner or both in the name of the audit firm and the engagement partner. The auditor also declares his professional accountancy designation and membership number as well as his FRC number.

12. Date of the Report

The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

- a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

13. Auditor's Address

The report should name the location in the country where the auditor practices

NOTE

The description of the auditor's responsibilities for the audit of the financial shall be included either:

- a) Within the body of the auditor's report; or
- b) Within an appendix to the auditor's report (the report shall include a reference to the location of the appendix); or
- c) By the specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

3.3 Content of Auditor's Report (Summary of matters to be expressly stated in the auditor's report): Schedule 6, CAMA, Cap C20. LFN 2004

Schedule 6, CAMA, Cap C20, LFN 2004 stipulates that the auditors' report shall include specific statements to the effect that:

- a) They have obtained all information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit
- b) In their opinion proper books of account have been kept by the company, so far as appears from their examination of those books and proper returns adequate for the purpose of their audit have been received from branches not visited by them.
- c) In their opinion the balance sheet (statement of financial position) and the profit or loss account (statement of comprehensive Income) dealt with by the report, are in agreement with the books of account and returns.

- d) In their opinion, and to the best of their information and according to the explanations given them, the financial statements give a true and fair view.
- e) In the case of a holding company, in their opinion, the group financial statements have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries and associates.

3.4 ISA 705 MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Types of Modified Opinions

This ISA establishes three types of modified opinions, namely. A qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

The nature of the matter giving rise to the modification, that is, whether financial statements are materially misstated or , in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Determining the Type of Modification to the Auditor's Opinion

Qualified Opinion (except for opinion): The auditor shall express a qualified opinion when:

- a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- b) The auditor is unable to obtain sufficient appropriate audit evidence on which

to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidences, concludes that misstatements, individually or in aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion: The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Reasons for modified report

1. **Material Misstatements:** **ISA 450** defines a misstatement as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

Accordingly, a material misstatement of the financial statements may arise in relation to:

- A. The appropriateness of the selected accounting policies
- B. The application of the selected accounting policies
- C. The appropriateness or adequacy of disclosures in the financial statements

2. **Scope limitation:** The auditor's inability to obtain sufficient appropriate audit evidence also referred to as limitation on the scope of the audit and this may arise from:

- A. Circumstances beyond their control
- B. Circumstances relating to the nature or timing of the auditor's work or
- C. Limitations imposed by management. In this situation, first communicate to management the need to remove the limitation. If management refuses, communicate with those in charge of governance and consider performing alternative procedure to gather the necessary evidence. If alternative procedures are not adequate the auditor should withdraw from the audit (if practicable), Otherwise disclaimer an opinion on the financial statements.

Basis for modification paragraph

Whenever the auditor expresses a modified opinion, a clear description of all the substantive reasons should be included this paragraph and, unless impracticable, a quantification of the possible effect (s) on the financial statements and the areas affected.

The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion", as appropriate.

If there is a material misstatement of the financial statements that relates to narrative disclosures or non-disclosures of information required, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated or the nature of the disclosure omitted.

Unless prohibited by law or regulation. The auditor may include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Opinion Paragraph

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion", "Adverse Opinion", or "Disclaimer Opinion" as appropriate, for the opinion

paragraph.

MATTERS THAT DO NOT AFFECT THE AUDITOR'S OPINION

Emphasis of matter (EOM): In certain circumstances, the auditor's report may be modified by adding an emphasis of matter paragraph to highlight and draw users' attention to a matter presented or disclosed in the financial statements which is fundamental to an understanding of the financial statements. Such a matter usually is extensively discussed in a note to the financial statements. ISA 706 states that the paragraph must only be used when the auditor has sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. EOM does not relate to a disagreement or a limitation in scope, and therefore is not in any way a qualification of the audit opinion. It is not a substitute for:

Reporting in accordance with ISA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;

A modified opinion when required by the circumstances of a specific audit engagement; or

Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation

Depending on the nature of information to be communicated, the paragraph may be placed after the basis of opinion to provide appropriate context to the auditor's opinion or either directly before or after the Key Audit Matters section, based on the auditor's judgement as to the relative significance of the information included in the Emphasis of Matter paragraph.

Emphasis of matter paragraph may be added under the following circumstances:

1. To highlight an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
2. To highlight a significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
3. Early application (where permitted) of a new accounting standard that has a material effect

on the financial statements.

4. A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Other Matter (OM) Paragraph

An Other Matter (OM) paragraph, like the EOM does not modify the auditor's opinion. However, it refers to information that is rightly not present in the financial statements, but which is so important for user's understanding of them that it needs to be highlighted in the auditor's report. It highlights matters relevant to other reporting responsibilities of the auditor. The OM is thus a means for the auditor to communicate with users, and should state explicitly that the matter referred to is not required to be included in the financial statements.

Examples of such situations include:

1. Where local law, regulation or generally accepted requires or permits the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon e.g the planning and scoping of the audit.
2. Where the auditor is not able to withdraw from an engagement even when a limitation on the scope of the audit imposed by management is pervasive (OM used to explain why)
3. Where the auditor may be reporting on more than one set of financial statements (e.g a set of statements prepared under national GAAP, and a set prepared under IFRS)
4. Any restrictions on the distribution of the auditors' report: If the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.
5. If revision of 'other information' issued with audited financial statements (e.g information in the director's report inconsistent with figures in financial statement) is

considered necessary by the auditor but management refuses to make the revision.

Placement of OM paragraph

- i.** When a Key Audit Matters section is presents in the auditor’s report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading ‘‘Other Matter’’, such as ‘‘Other Matter – Scope of the Audit’’, to differentiate the other matter paragraph from the individuals matters describes in the Key Audit Matters section,
- ii.** When an Other paragraph is included to draw users’ attention to a matter relating to other reporting responsibilities addressed in the auditor’s report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
- iii.** When relevant to all the auditor’s responsibilities or users’ understanding of the auditor’s report, the Other Matter paragraph may be included as a separate section following the Report on Other Legal and Regulatory Requirements.

SELF ASSESSMENT QUESTIONS

1. Why are audit reports important and explain the usefulness of an audit report?
2. What are the elements contained in an audit report and who are the users of audit report?

3.5 INTERNAL AUDIT REPORTS

Internal auditors, external auditors, and consultants who perform internal audit and review engagements provide reports to management and this reports are referred to as internal audit reports. These reports are important because they provide documentary evidence of the work performed, the conclusions reached and the recommendations made. The quality and presentation of such reports makes a substantial difference to the value added by internal audit and those performing similar functions

Internal audit reports are different to statutory auditors’ reports by external auditors because statutory reports are governed by legislation and either national auditing standards, or International Standards on Auditing. Statutory auditors’ reports are highly codified, and usually fairly brief by

comparison with internal audit reports, and they are often available for public inspection. Statutory auditors' reports are produced for the benefit of shareholders and other stakeholders whereas internal audit reports are produced for the benefit of management; they are generally private documents and are not available for public inspection.

On the other hand, internal audit reports are similar, in some respects, to reports to management on the design and implementation of controls provided by external auditors to management during the course of and the end of, statutory audits. The method of production of such reports is similar, for example, both internal and external auditors draft these sort of reports on the basis of the findings of their work and there would usually be a split between significant and insignificant matters. Draft reports will often be discussed with management to establish management's likely response. Responses are often incorporated into the report, reports are often redrafted several times, particularly in large organisations, after which reports will be issued. If management have not commented at an earlier stage, a formal response may be expected later. It is normal to follow up on recommendations or agreed action points in order to establish how the issues have been dealt with.

External auditor reports to management typically called **Letter of weakness/Management Letter** deal in substance with, inter alia, issues relating to the design and implementation of internal controls that have come to the external auditors' attention during the course of the statutory audit. They generally deal with weaknesses in systems, the potential consequences and provide recommendations to management. Whilst internal audit reports may appear to be similar, they are different in substance. Internal audits engagements are usually undertaken as part of the pre-planned program of work with a variety of objectives as part of an entity's overall corporate governance arrangements. These objectives can relate to risks faced by the business, internally and externally, and/or they can deal with the enhancement of performance.

Whilst there are common elements to the two types of reporting, risk-based reporting tends to look at the current position and internal issues, whereas enhancement of performance tends to be more outward and forward looking. Risk based reports might include establishing whether existing systems are properly aligned with the overall objectives of the entity. For example, internal

auditors may be requested to establish whether human resources systems are capable of, and are actually delivering, the development and retention of best staff in an entity's particular market. Where it is believed that systems are not properly aligned, internal audit may be requested to make recommendations in relation to changing the existing systems, or implementing new systems, in order to achieve corporate objectives. Report relating to the enhancement of performance may involve a review of the market, and management's business strategies and overall risk management systems at a higher level. Whatever the assignment, there will almost always be a formal report which should be clear, balanced and constructive, consistent in manner of style.

4.0 CONCLUSION

Audit reports are the end results of every audit assignment and stakeholders, management etc make decisions based on this result. Reasons why auditor issues a qualified, adverse and an unqualified report were stated.

5.0 SUMMARY

An audit report is a written opinion of an auditor regarding an entity's financial statements. The report is written in a standard format, as mandated by generally accepted auditing standards.

An auditor evaluates evidence obtained during the audit to ensure they are sufficient and appropriate to support his opinion. The independent auditor's report may present a clean opinion if there are no material misstatements in the financial statements or may be modified for reasons of disagreement with management on some accounting treatments or limitation on scope of auditor's work imposed by management, preventing the auditor from gathering sufficient appropriate evidence on which to base his opinion. The report may also be modified to highlight and draw users' attention to a matter presented or disclosed in the financial statements which is fundamental to an understanding of the financial statements, by the addition of "Emphasis of matter paragraph."

The auditor also issues a management letter (letter of weakness) to those charged with governance to highlight identified weaknesses in internal control and other matters of governance interest.

6.0 Tutor marked assignment

1. Explain the difference between an internal audit report and an external audit report.
2. Discuss the types of audit opinion and the reasons for modification of audit opinion
3. What is a letter of weakness?

7.0 References/Further reading

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4. FGN (2004). Companies and Allied Matters Act,Cap C20, LFN 2004
5. ICAN (2014): Study Pack on Advanced Audit and Assurance, Lagos: VI Publishing Ltd
6. International Standards on Auditing 700, 701, 705 and 706.