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AND ECONOMICS DEPARTMENT OF
ACCOUNTING AND FINANCE**



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Preface

Auditing financial statements and its sub sections include; cash and marketable securities, accounts receivable and sales, inventories and cost of goods sold, current liabilities, fixed assets, debt and equity capital. Understanding and Practicing audit is vital to the organizations, to make a decision for investors, for the academicians and for the government at large.

Hence, this module builds on the knowledge gained in Auditing II and it covers an in depth practical aspects of topics introduced in Auditing principles and practice II and brings in new concepts as well. The technical application of auditing programs and procedures for balance sheet and income statement accounts in an audit undertaking are the foremost subject matters of the module. This module includes detail about sampling in auditing, rationale for and methods of audit sampling, audit of cash and marketable Securities, receivable and sales audit , inventory and cost of goods sold audit, fixed assets audit including (property, plant & equipment), audit of current liabilities including (accounts payable & notes payable), debt and equity capital .

The general objective of the module is to equip and acquaint students the skills needed to render depth practical aspects of topics introduced in Auditing II and brings in new concepts as well. The course introduces audit sampling in general and goes on to application of statistical tools in tests of controls and balances. The technical application of auditing procedures for balance sheet and income statement accounts in an audit undertaking are the foremost subject matters of the course. Audit of systems that include EDP application along with tools and techniques used in evaluation and understanding of internal control in such environments will be introduced.

And also to provide an opinion on the reasonableness of financial statements audit with respect to applicable criterias. And specifically, Apply knowledge of sampling methods in auditing, rationale for auditing, standards, techniques and procedures to practical situations commonly encountered relative to an opinion audit; be acquainted the principles that underlie audit of Balance Sheet and Income Statement accounts; to acquire the knowledge about the audit program and procedures of fixed asset like property, plant and equipment, depreciation, accounts payable and other liabilities(debt) and equity capital; develop audit program and procures for the audit of major accounts; and comprehend the significance of professional competence, independence, and mental integrity in the practice of accountancy; to grasp the

knowledge about internal, operational and compliance audit, audit of different organizations and to solve the real audit cases of different organizations and be committed to bringing about a prevalence of good reporting practice and contribute to the pursuit of social justice and fairness.

*To sum up, this module is written in a clear and understandable manner comprising a number of activities and self- test exercises at the end of each chapter. The activities and self -test exercises are intended to make you not to jump a topic without fully understanding it and make sure that you have done them entirely. Answer all the self- test exercises and check your progress by referring the **answers given at the back of the module** after completing each chapter*

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CHAPTER ONE

AUDIT IN SAMPLING

Definition:

Audit sampling is the application of audit procedures to less than 100% of the total population and all the items in the population have the same chance to be selected.

Sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

This is to ensure that the items selected represent the total population which enables the auditor to draw auditors to draw their conclusion and express their opinion based on their predetermined objective.

Audit sampling is really important because it doesn't only help auditors to gather sufficient and appropriate audit evidence to draw the audit's opinion, but also plays a very important part in the audit's work's efficiency and effectiveness. That means auditor is not required to check 100% of object or items to let them express their opinion.

To ensure that the selected items could represent the total population, the selection process and methods should not involve too much from human judgments and should be avoiding bias from auditors. They only perform their review and verification on the selected items and then express their opinion on the entire population. In general, audit sampling can be performed in two different types.

HISTORY

The Department has used sampling in its audit procedures for many years. That sampling, for the most part, has been block sampling. That is, taking a period of time and testing 100% of the records during that time. Until 1990, the Department's policy on sampling was to take 100% samples from three test months per year selected for being the high, low and average months of the year. From 1990 forward the Department has adopted other systematic or random sampling techniques.

Random sampling techniques are both convenient and accurate when performed properly, for these reasons sampling is the rule rather than the exception in most audits performed by the Department. The convenience and accuracy extends to taxpayers as well. Audits based on sampling have been challenged. When challenged we have allowed the taxpayer to present detailed information to refute the results of the sample.

PURPOSE OF AUDIT SAMPLING

Sampling is performed because it is more efficient than testing 100% of a population. In tax audits, if the taxpayer and the Department can agree on a representative sample, it can save both parties time and money. By definition, any procedure that does not examine 100% of the items in question is a sampling procedure.

Objectives of audit sampling

Audit sampling is very important part of audit works. No matter it is a financial audit, internal audit, and other kind of audit, audit sampling still needs to be used by the auditors. Audit sampling also part of the audit standards requirements and it could help auditors to meet their objective with less effort.

The following are the objectives of audit sampling:

- To gather audit evidence in order to conclude audit opinion
- To reduce the works yet audit yet still help audit to reach its conclusion
 - To detect any kind of error or fraud that could happen in the company as well as financial statements.
- To provide the basis for the auditor to conclusion audit opinion.
 - To prove auditors have done their jobs based on te required auditing standards. Use as a tool for investigations.

Two types of auditing sampling:

Statistical audit sampling:

Statistical audit sampling is the sampling approach where auditor uses random sampling to select the items from the total population use the probability technique to measure the result of the testing and make a conclusion.

Using statistical sampling is very important to help the auditor to manage and control te audit's risk. This is because statistics, we use data and probabilities to select the items from the total population and those data are not prejudged and unbiased by auditors.

This statistical sampling normally performs where the total population is more than 100 items. Based on experiences, there are many different tools available in the market that we use could use to perform audit sampling. And, if you don't have the tool, you can use the function in excel instead of software.

In statistical sampling, you can consider select 10 items from the total population randomly or you can set internal every item that reaches the interval set. That means every item among 100

items has the same chance to be selected for verification. Once you completed your testing, and got the result and then make a conclusion base on the result.

So, this is how statistical sampling looks like and how it is using. The two important things you need to remember about statistical sampling are the items are selected randomly and the conclusion is made based on the result of testing. If either of these two things is not meet, then the sampling is called non-probability sampling.

Non-statistical audit sampling:

Non-statistical sampling is different from statistical sampling. Based on the theory from ISA, any methods that not mean the criteria of the statistic are non-statistic. That means you have to be very clear and understand well about statistic audit sampling. There are two important things that can use to identify whether the sampling is systematic or not.

The fist one is selection of data or items are not random. That means the selections are based on judgment. Second, the result from testing from that selections is not using to conclude for the entire population.

The auditor might not use statistical audit sampling to select items for testing. Instead, they might select the items based on:

Value of items, for example, the top ten highest values.

Select the items that higher than a certain amount or value. For example any items higher than 200,000 USD.

Items that contain information or data they want to assess. For example, any purchasing transactions from supplier name dalata.ltd.

These methods of sampling are called non-statistic.

Five methods of audit sampling

- 1) Random selection: it is the type of sampling that provides equal opportunities to all items or units in the total population. This kind of selection could use in excel or other generating tools.
- 2) Systematic selection: involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection, auditors must ensure that the population dos not structure in such a manner that the sampling interval corresponding with a particular pattern in the population.
- 3) Haphazard: selection may be an alternative to the random selection provided auditors satisfy that the sample is representative of entire population. This method requires care to guard against making a selection that is biased, for example towards items that are easily

selected, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.

- 4) Block selection: maybe use to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year. Block sampling may; however, produce samples that are not representative of the population as a whole, particularly if errors only occurred during certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
- 5) Monetary unit sampling: it is type of value-weighted selection in which sampling size, selection, and the evaluation result in the conclusion in monetary amounts. Monetary unit sampling is a kind of systematic audit sampling.

WHEN NOT TO SAMPLE

There are many audit procedures which do not involve sampling.

Inquiry and Observation:

Reviewing records for the method of accounting and other information. Observing accounting procedures.

Discussing methods of accounting and reporting with taxpayer.

Scanning documents for possible issues.

Analytical Review Procedures:

Comparing records reports and other information.

Recomputing or estimating amounts. Reviewing trends in reporting. Comparing similar businesses.

One-Hundred Percent Examination:

Reviewing all fixed asset purchases, where appropriate.

Examining all contracts, where there are a small number.

Reconciling each years gross receipts to CIT A sales factors or Schedule C receipts.

Zero Percent Examination

This occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested

Note: Even though 100% examination may be done where appropriate. It is not mandatory for any particular taxpayers or tax programs. Sampling procedures discussed below may be more cost effective.

SAMPLING RISK

Overall tax audit risk is made up of the risk of inaccurate records and the risk of misapplication of the tax law. Both of these risks are made up of two components as well.

1. Risk that there are errors (inherent risk).
2. Risk that procedures will not find errors (audit risk).

Audit risk, in turn is made up of two components, the risk that a procedure is not effective and sampling risk. Sampling risk is the probability that the sample results are not representative of the entire population. In general, factors that may lessen sampling risk include:

1. Taking larger size samples
2. Using random sample selection methods
3. Stratifying the sample
4. Properly defining the test objective
5. Properly defining a deviation
6. Exclusion of non-recurring, non-systematic errors.
7. Properly evaluating errors.

DESIGNING A SAMPLING APPLICATION

There are several steps in designing a sampling application for an audit or investigation. The steps are discussed in detail in the next pages.

1. Define the objectives of the test
2. Determine the type of test to be performed
 - a. Variables Sampling
 - b. Attribute Sampling
3. Define the deviation conditions
4. Define the population

- a. Decide what period will be covered by the test
 - b. Define the sampling unit
 - c. Consider the completeness of the population
 - d. Consider how the error rate will be extrapolated
5. Determine the method of selecting the sample
- a. Random-Number sampling
 - b. Systematic sampling
 - c. Other sampling
6. Determine the sample size
- a. Variables Sampling
 - b. Attribute Sampling
7. Perform the sample
- a. Compare the sample to the population before completing the sample
8. Evaluate the sample results
- a. Interpret results
 - b. Extrapolate results
 - C. Consider the qualitative aspects of the deviations
 - d. Reaching an overall conclusion about the population
9. Document the sampling procedure

CHAPTER TWO

AUDIT FOR CASH AND MARKETABLE SECURITIES

2.0. Learning objectives

At the end of this chapter, learners should be able to:

Show the relationship of cash in the bank to the various transaction cycles. Identify the major types of cash accounts maintained by business entities. Design and perform audit tests of the general cash account.

Recognize when to extend audit tests of the general cash account to test further for material fraud.

Design and perform audit tests of the imprest payroll bank account. Design and perform audit tests of imprest petty cash.

Explain the nature of cash receipts and disbursements.

Explain the fundamental internal controls over each receipts and cash disbursement.

Describe the nature of appropriate procedures to accomplish the objectives of cash audit.

2.1. Introduction

Dear Learners! At this point it is important to know that cash is the only account included in every cycle except inventory and warehousing. It makes sense to study this audit area last because the evidence accumulated for cash balances depends heavily on the results of the tests in other cycles. For example, if the auditors' understanding of internal control and tests of controls and substantive tests of transactions in the acquisition and payment cycle cause them to believe that it is appropriate to reduce assessed control risk to low, they can reduce detailed tests of the ending balance in cash. If, however, auditors conclude that assessed control risk should be higher, extensive year-end testing may be necessary.

Cash is important because of its susceptibility to theft, and cash can also be significantly misstated. This chapter highlights the linkage of cash in the bank to transaction cycles and describes substantive tests of the cash balance. Thus, in this chapter we are going to examines the

audit of cash. For the audit of cash much reliance is placed on third party confirmation of cash balance.

You should bear in mind that the control of cash is of prime importance in any business. The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with generally accepted accounting principles. In most audits, the primary assertions that generate audit risk for ***cash are existence, completeness, right and obligation, and presentation and disclosure.***

2.2. Cash in the bank and transaction cycles

The item cash reported in the financial statements represents currency on hand and cash on deposit in Bank accounts, including certificate of deposit, time deposits, and saving accounts. Certain “cash equivalents” are combined with cash for presentation in the financial statements. FASB statement of financial accounting standards No 95, statement of cash flow”, defines cash equivalents as short – term, highly liquid investments that are readily convertible to cash or so near to their maturity that there is little risk of change in their value. Examples of such type include Treasury bills, commercial paper and money market funds.

Cash is affected in one or another, by all of the entity’s transaction cycles. Although the main source of cash is revenue, other sources of cash include (1) the sale of property, plant, and equipment and (2) the proceeds from issuing long – term debt or capital stock - the main source of disbursements are the purchasing and payroll.

A brief discussion of the relationship between cash in the bank and the other transaction cycles serves a dual function:

1. It shows the importance of audit tests of various transaction cycles on the audit of cash.
2. It aids in further understanding the integration of the different transaction cycles.

Since every transaction involves cash, we can say that the focal point being the general cash account (“Cash in bank”). By examining the involvement of cash in every transaction, it is apparent why the general cash account is considered significant in almost all audits, even when

the ending balance is immaterial. The amount of cash **flowing** into and out of the cash account is often larger than that for any other account in the financial statements. Furthermore, the susceptibility of cash to embezzlement is greater than for other types of assets because most other assets must be converted to cash to make them usable.

In the audit of cash, auditors must distinguish between verifying the client's reconciliation of the balance on the bank statement to the balance in the general ledger, and verifying whether recorded cash in the general ledger correctly reflects all cash transactions that took place during the year. It is relatively easy to verify the client's reconciliation of the balance in the bank account to the general ledger, but a significant part of the total audit of a company involves verifying whether cash transactions are correctly recorded. For example, each of the following misstatements ultimately results in the improper payment of or the failure to receive cash, but none will normally be discovered as a part of the audit of the bank reconciliation:

- Failure to bill a customer

 - An embezzlement of cash by intercepting cash receipts from customers before they are recorded, with the account charged off as a bad debt

- Duplicate payment of a vendor's invoice

 - Improper payments of officers' personal expenditures

 - Payment for raw materials that were not received

- Payment to an employee for more hours than he or she worked

- Payment of interest to a related party for an amount in excess of the going rate

Entirely different types of misstatements are normally discovered as a part of the tests of the bank reconciliation. These include:

- Failure to include a check that has not cleared the bank on the outstanding check list, even though it has been recorded in the cash disbursements journal

- Cash received by the client subsequent to the balance sheet date but recorded as cash receipts in the current year

- Deposits recorded as cash receipts near the end of the year, deposited in the bank in the same month, and included in the bank reconciliation as a deposit in transit

- Payments on notes payable debited directly to the bank balance by the bank but not entered in the client's records



QUICK CHECK

1. Discuss different types of misstatements that are normally discovered as a part of the tests of the bank reconciliation.

2.3. The auditors' objectives in examination of cash

The auditors have five objectives in the audit of cash:

- 1 Consider internal control over cash transactions.
- 2 Determine the existence of recorded cash and the client's ownership of this asset.
- 3 Establish the completeness of recorded cash.
- 4 Establish the clerical accuracy of cash schedules.
- 5 Determine that the statement presentation of cash is appropriate.

The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with generally accepted accounting principles. The detail being:

- ✚ Establish available cash i.e. see the cash that is to be there
- ✚ Prove the cash that ought to be there
- ✚ Prove the cash on hand is needed or not
- ✚ Check independent accountability for cash transactions
- ✚ Prove disbursements authorization
- ✚ Prove handling of receipts
- ✚ Prove cash protection
- ✚ Establish management reporting methods and timely monitoring

2.4. Internal control over cash

Control objectives

The central control objectives are that:

All sums are received and subsequently accounted for.

All payments are made which should not be made.

All receipts and payments are promptly and accurately recorded.

Control procedures

A detailed study of the operating routines of the individual business is necessary in developing the most efficient control procedures. These universal rules for achieving internal control over cash may be summarized as follows:

- 1 Do not permit any one employee to handle transaction from beginning to end.
- 2 Separate cash handling from record keeping.
- 3 Centralize receiving of cash as much as possible.
- 4 Record cash receipts immediately.
- 5 Encourage customers to obtain receipts and observe cash register totals.
- 6 Deposit each day's cash receipts intact.
- 7 Make all disbursements by cheques with the exception of small from petty cash.
- 8 Have monthly bank Reconciliation prepared by employees not responsible for the issuance or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.
- 9 Forecast expected cash receipts and disbursements and investigate variances from forecasted amounts.

QUICK CHECK

2. List the auditor's objectives in examination of cash.

2.4.1. Internal control over cash receipts

Cash receipts resulted from a variety of activities. For example, cash is received from revenue transactions, short and long term borrowings, the issuance of stock, and the sale of marketable securities, long term investments, and other assets. The scope of this section is limited to cash receipts from cash sale and collection from customers on credit sales. The basic internal controls over cash receipts include the following:

Authority to collect cash should be clearly defined.

Collections should be recorded when received.

The collector's cash receipts should be reconciled to the eventual banking. Receipts should be banked immediately.

Each day's receipts should be recorded promptly in the cashbook.

Sales ledger account should have no access to the cash.

The processing of receipts from cash and credit sales involves the following cash receipts functions:

Receiving cash receipts.

Depositing cash in bank.

Recording the receipts.

Segregation of duties in performing these functions is an important internal control activity.

Receiving cash receipts: A major risk in processing cash receipts transactions is the possible theft of cash before and after a record of cash is made. Thus, control procedures should provide reasonable assurance that documentation establishing accountability is created at the moment cash is received and that the cash is subsequently safeguarded.

Depositing cash in bank: Proper physical controls over cash require that all cash receipts be deposited intact daily. Intact means all receipts should be deposited; that is cash disbursements should not be made out of un-deposited receipts.

Recording the cash receipts: This function involves journalizing over the counter and mail receipts and posting mail receipts to customer accounts. Controls should ensure that only valid receipts are entered and that all actual receipts entered at the correct amount. To ensure that only valid transactions are entered, physical access to the accounting records or computer terminals used in recording should be restricted to authorized personnel.

The Internal control objectives for cash receipts can be summarized as follows:

Occurrence: Trace a sample of entries in the cash receipts journal to remittance advices, daily deposit slips, and bank statement.

Completeness: Trace a sample of remittance advices to cash receipts journal and, if necessary, to deposit slips.

Authorization: For a sample of days, examine the signature on the deposit slip and the check endorsements for proper authorization.

Accuracy: For a sample of daily deposits, foot the remittance advices and entries on the deposit slip and agree to the cash receipts journal and bank statement. For a sample of weeks, foot the cash receipts journal and agree posting to the general ledger.

Cutoff: Compare the dates for recording a sample of cash receipts transactions in the cash receipts journal with the dates the cash was deposited in the bank (note any significant delays). Observe cash on hand for the last day of the year, and trace deposits to cash receipts journal and cutoff bank statement.

Classification: Examine a sample of remittance advices for proper account classification.

Table 2.1. Summary of Assertions, Possible Misstatements, Control Activities, and Tests of Controls for Cash Receipts Transactions

Assertion	Possible Misstatement	Control Activity	Test of Controls
Occurrence	Cash receipts recorded but not received or deposited	Segregation of duties. Use of lockbox system. Monthly bank reconciliations prepared and independently reviewed.	Observation and evaluation of proper segregation of duties. Inquiry of management about lockbox policy. Review of monthly bank reconciliation for indication of independent review.
Completeness	Cash receipts stolen or lost before recording	Same control procedures as above. Checks restrictively endorsed when received and daily cash list prepared. Daily cash receipts reconciled with posting to accounts receivable subsidiary ledger. Customer statements prepared on a regular basis; complaints handled independently.	Same tests of controls as above. Observation of the endorsement of checks. Testing of the reconciliation of daily cash receipts with posting to accounts receivable subsidiary ledger. Inquiry of client personnel about handling of monthly statements and examination of resolution of complaints.

Authorization	Cash discounts not properly Taken	Procedures specifying policies for cash discounts	Testing of a sample of cash receipts transactions for proper cash discounts.
Accuracy	Cash receipts recorded at incorrect amount	Daily remittance report reconciled to control listing of remittance advices. Monthly bank statement reconciled and independently reviewed.	Review and testing of reconciliation. Examination of monthly bank reconciliation for independent review.
Cutoff	Cash receipts recorded in wrong period	Use of a lockbox system or a control procedure to deposit cash receipts daily	Examination of cash receipts for daily deposit.
Classification	Cash receipts posted to wrong customer account Cash receipts not properly posted to general ledger accounts Cash receipts recorded in wrong financial statement account	Daily remittance report reconciled daily with postings to cash receipts journal and accounts receivable subsidiary ledger Monthly customer statements with independent review of complaints Monthly cash receipts journal agreed to general ledger posting Accounts receivable subsidiary ledger reconciled to general ledger control account Chart of accounts	Review and testing of reconciliation; if IT application, testing of application controls for posting. Review and testing of client procedures for mailing statements and handling complaints from customers. Review of posting from cash receipts journal to the general ledger. Examination of reconciliation of accounts receivable subsidiary ledger to general ledger control account. Tracing of cash receipts from listing to cash receipts journal for proper classification. Review of cash receipts journal for unusual items.

QUICK CHECK

3. Discuss the internal control objectives for cash receipts.

1.4.2. Internal control over cash disbursements

There are two cash disbursements functions as follows:

- 1 Paying the liability
- 2 Recording the cash disbursements.

These functions should not be performed by the same department or individual. The basic internal controls over cash disbursements include:

Unused checks should be held in a secure place.

The person who prepares checks should have no responsibility over purchase ledger or sales ledger.

Checks should be signed only when evidence of a properly approved transaction is available.

These checks should be evidenced by signing the supporting documents.

Check signatories should be restricted to the minimum practical number.

Two signatories at least should be required except perhaps for checks of small amounts. Checks should be crossed before being signed.

Supporting documents should be cancelled as paid to prevent their use to support further check payments.

Checks should preferably dispatch immediately.

The Internal control objectives for cash disbursements can be summarized as follows:

Validity - It refers that segregation of duties must be made to check possible misstatements such as cash disbursement recorded may not be made (occurred).

Completeness – It refers that all transactions of the given period which are made or occurred must be included or recorded in records. However, there might be cash

disbursements made or occurred but not recorded or included. Auditors have to check numerical sequence of checks; daily cash disbursements reconciled to postings to accounts payable subsidiary records.

Timeliness – It refers that all disbursement transactions must be recorded in proper time then, the internal control objective helps to prevent cash disbursements not to be recorded in a wrong period. In control procedure, there would be daily reconciliation of checks issued with postings to cash disbursements journal and accounts payable subsidiary records.

Authorization – It refers that there must be appropriate authorization of disbursement transactions by concerned personnel. Control procedure to insure this objective is segregation of duties; checks must be prepared only after all source documents have been independently approved.

Valuation – It refers that cash disbursements must be properly determined. The balances of cash disbursements must be determined accurately. There might be incorrect amount of cash disbursed and recorded in journal; therefore, there must be a control procedure to check this misstatement. Daily cash disbursements report must be reconciled to checks issued; vendor statements must be reconciled to accounts payable records, and independently reviewed, monthly bank statements must be reconciled and independently reviewed.

Classification - The cash disbursements must be properly classified to in accordance with chart of accounts. Therefore, there might be cash disbursements charged to wrong account. The control procedure includes that there must be well – prepared chart of accounts, independent approval and review of general ledger account on voucher packet. Examine a sample of canceled checks for proper account classification

Posting and summarization – It refers that all cash disbursement transactions must be posted and summarized. There might be cash disbursement posted to the wrong vendor accounts, or cash disbursements journal may not be summarized properly or not properly posted to general ledger accounts. Then, there must be reconciled and independently reviewed, monthly cash disbursements journal agreed must agree to general ledger postings, Accounts payable subsidiary records must be reconciled to general ledger control account.

Table 2.2. Summary of Assertions, Possible Misstatements, Control Activities, and Tests of Controls for Cash Disbursement Transactions

Assertion	Possible Misstatement	Control Activity	Test of Controls
Occurrence	Cash disbursement recorded but not made	Segregation of duties Vendor statements independently reviewed and reconciled to accounts payable records Monthly bank reconciliations prepared and reviewed	Observe and evaluate proper segregation of duties. Review client's procedures for reconciling vendor statements. Review monthly bank reconciliations for indication of independent review.
Completeness	Cash disbursement made but not recorded	Same as above Accounting for the numerical sequence of checks Daily cash disbursements reconciled to postings to accounts payable subsidiary records	Same as above Review and test client's procedures for numerical sequence of checks; if IT application, test application controls. Review procedures for reconciling daily cash disbursements with postings to accounts payable subsidiary records; if IT application, test application controls.
Authorization	Cash disbursement not Authorized	Segregation of duties Checks prepared only after all source documents have been independently approved	Evaluate segregation of duties. Examine indication of approval on voucher packet.
Cutoff	Cash disbursement recorded in wrong period	Daily reconciliation of checks issued with postings to the cash disbursements journal and accounts payable subsidiary records	Review daily reconciliations.
Accuracy	Cash disbursement recorded at incorrect amount Cash disbursement posted to the wrong vendor account Cash disbursements journal not summarized	Daily cash disbursements report reconciled to checks issued Vendor statements reconciled to accounts payable records and independently reviewed Monthly bank statements reconciled and independently reviewed	Review reconciliation. Review reconciliation. Review monthly bank reconciliations. Review reconciliation. Review postings from cash disbursements journal to the general ledger. Review reconciliation.

	properly or not properly posted to general ledger accounts	Accounts payable subsidiary records reconciled to general ledger control account	
Classification	Cash disbursement charged to wrong account	Chart of accounts Independent approval and review of general ledger account on voucher packet	Review cash disbursements journal for reasonableness of account distribution. Review general ledger account code on voucher packet for reasonableness.

QUICK CHECK

4. Discuss the internal control objectives for cash receipts.

1.5. Balance-Related Assertions

The major audit procedures for each cash account involve tests of the bank reconciliation. The approach to auditing bank reconciliation is basically the same regardless of the type of bank account being examined. However, the type and extent of the audit work are more detailed for the general cash account because it normally represents a material amount and because of the large amount of activity in the account.

Table 2.3. Examples of Tests of Details of Balances for Cash

Assertions about Account Balances at Period End	Tests of Details Account Balances
Existence Completeness Valuation and Allocation	Test bank reconciliation for each account: Foot the reconciliation and the outstanding check listing. Trace balances per book to the general ledger. Obtain standard bank confirmation and trace balance per bank to the bank reconciliation. Obtain cutoff bank statement. Trace deposits in transit, outstanding checks, and other reconciling items to cutoff bank statement.
	If control risk is high or if fraud is suspected: Perform extended bank reconciliation procedures. Perform a proof of cash. Test for kiting.

2.6. Types of cash accounts

Before dealing with audit tests of the client's bank reconciliation, it is helpful to discuss the types of cash accounts commonly used by most companies, because the auditing approach to each varies. Auditors are likely to learn about the various types of cash balances when they obtain an understanding of the client's business. In spite of the sophisticated nature of cash management, the entity's management must still be concerned with the control and safekeeping of cash. The use of different types of bank accounts aids in controlling the entity's cash. The following types of bank accounts are typically used:

1. General cash account
2. Imprest cash accounts and
3. Branch accounts

General cash account

The **general cash account** is the focal point of cash for most organizations because virtually all cash receipts and disbursements flow through this account. For example, the disbursements for the acquisition and payment cycle are normally paid from this account, while the receipts of cash in the sales and collection cycle are deposited in the account.

Impress cash account

Impress cash account contains a stipulated amount of money, and the account is used for limited purposes. This account is usually used for disbursing of payroll checks and the account contains a minimum balance.

Disbursement may be by check or direct deposit. Prior to the disbursement of payroll, a check is drawn or a cash transfer is made from the general cash account to the payroll account for the amount of the net payroll. The payroll is then drawn on this imprest account. Thus, the payroll account serves as a clearing account for payroll payments and facilitates the disbursement of cash while also maintaining adequate control over cash. Use of imprest accounts also minimizes the time required to reconcile the general cash account.

Branch bank accounts

For a company operating in multiple locations, it is often desirable to have a separate bank balance at each location. **Branch bank accounts** are useful for building banking relations in local communities and permitting the centralization of operations at the branch level.

In some companies, the deposits and disbursements for each branch are made to a separate bank account, and the excess cash is periodically transferred electronically to the main office general bank account. The branch account in this instance is much like a general account, but at the branch level.

Imprest petty cash fund

An **imprest petty cash fund** is not a bank account, but it is sufficiently similar to cash in the bank to merit inclusion. A petty cash account is often something as simple as a preset amount of cash set aside in a cash box for incidental expenses. It is used for small cash acquisitions that can be paid more conveniently and quickly by cash than by check, or for the convenience of employees in cashing personal or payroll checks. An imprest cash account is set up on the same basis as an imprest branch bank account, but the expenditures are normally for much smaller amounts. Typical expenses include minor office supplies, stamps, and employee meals. A petty cash account usually does not exceed a few hundred dollars and is often reimbursed only once or twice each month.

Many organizations use pre-approved purchase cards (known as P-cards) to make miscellaneous purchases instead of maintaining a petty cash fund. These purchase cards function much like a credit card, but contain numerous restrictions on the nature and amount of purchases that can be made.

QUICK CHECK

1. What is meant by an imprest bank account for a branch operation? Explain the purpose of using this type of bank account.

2.7. Audit of the general cash account

It is important to note that all cycles, except inventory and warehousing, affect cash in the bank. In testing the year-end balance in the general cash account, the auditor must accumulate

sufficient appropriate evidence to evaluate whether cash, as stated on the balance sheet, is fairly stated and properly disclosed in accordance with five of the eight balance-related audit objectives used for all tests of details of balances (existence, completeness, accuracy, cutoff, and detail tie-in). Rights to general cash and its classification on the balance sheet are generally not of concern, and the realizable value of cash is not applicable.

The methodology for auditing year-end cash is essentially the same as that for all other balance sheet accounts and discussed in detail next which comprises the following points:

Identify Client Business Risks Affecting Cash

Most companies are unlikely to have significant client business risks affecting cash balances. However, client business risk may arise from inappropriate cash management policies or handling of funds held in trust for others. Client business risk is more likely to arise from cash equivalents and other types of investments. Several financial services firms have suffered large trading losses from the activities of individual traders that were hidden by misstating investment and cash balances. The auditor should understand the risks from the client's investment policies and strategies, as well as management controls that mitigate these risks.

Set Tolerable Misstatement and Assess Inherent Risk

The cash balance is not material on many audits, but cash transactions affecting the balance are almost always extremely material. Therefore, the potential often exists for material misstatement of cash. Because cash is more susceptible to theft than other assets, there is high inherent risk for the existence, completeness, and accuracy objectives. These objectives are usually the focus in auditing cash balances. Typically, inherent risk is low for all other objectives.

Assess Control Risk

Internal controls over year-end cash balances in the general account can be divided into two categories:

1. Controls over the transaction cycles affecting the recording of cash receipts and disbursements
2. Independent bank reconciliations

In preceding section, we discussed controls affecting the recording of cash transactions, which are essential in assessing control risk for cash. On the other hand, a monthly **bank reconciliation** of the general bank account on a timely basis by someone independent of the handling or recording of cash receipts and disbursements is an essential control over the ending cash balance.

The reconciliation ensures that the accounting records reflect the same cash balance as the actual amount of cash in the bank after considering reconciling items. More important, the *independent* reconciliation provides an opportunity for an internal verification of cash receipts and disbursements transactions. If the bank statements are received unopened by the reconciler, and physical control is maintained over the statements until the reconciliations are complete, copies of cancelled checks, duplicate deposit slips, and other documents included in the statement can be examined without concern for the possibility of alterations, deletions, or additions.

A careful bank reconciliation by competent client personnel includes the following actions:

- Compare cancelled checks or electronic bank records of payment with the cash disbursements records for date, payee, and amount
- Examine cancelled checks or electronic bank records of payment for signature, endorsement, and cancellation
- Compare deposits in the bank with recorded cash receipts for date, customer, and amount
- Account for the numerical sequence of checks, and investigate missing ones
- Reconcile all items causing a difference between the book and bank balance and verify their appropriateness for the client's business
- Reconcile total debits on the bank statement with the totals in the cash disbursements records
- Reconcile total credits on the bank statement with the totals in the cash receipts records
- Review month-end interbank transfers for appropriateness and proper recording
- Follow up on outstanding checks and stop-payment notices

Design and Perform Tests of Controls and Substantive Tests of Transactions

Because the cash balance is affected by all other cycles except inventory and warehousing, an extremely large number of transactions affect cash. Cash transactions are audited through all other cycles except inventory and warehousing transaction cycle tests.

Design and Perform Analytical Procedures

In many audits, the year-end bank reconciliation is extensively audited. Using analytical procedures to test the reasonableness of the cash balance is therefore less important than it is for most other audit areas. Auditors commonly compare the ending balance on the bank reconciliation, deposits in transit, outstanding checks, and other reconciling items with the prior-year reconciliation. Similarly, auditors normally compare the ending balance in cash with previous months' balances. These analytical procedures may uncover misstatements in cash.

Design Tests of Details of Cash Balance

The starting point for the verification of the balance in the general bank account is to obtain a bank reconciliation from the client for inclusion in the auditor's documentation. To audit cash in the bank, the auditor verifies whether the bank reconciliation received from the client is correct. The most important objectives are existence, completeness, and accuracy. Therefore, they receive the greatest attention. In addition to these balance-related objectives, the auditor also performs tests related to the four presentation and disclosure objectives, such as review of minutes and loan agreements to determine if there are restrictions on cash that must be disclosed. As in all other audit areas, the actual audit procedures depend on materiality and the risks in cash that the auditor has identified in other parts of the audit.

The following three procedures merit additional discussion because of their importance and complexity: receipt of a bank confirmation, receipt of a cutoff bank statement, and tests of the bank reconciliation.

 **Receipts of a Bank Confirmation** - Bank confirmations are not required for audits of non-public entities or under international auditing standards. However, auditors usually obtain a direct receipt of a confirmation from every bank or other financial institution with which the client does business, except when there is an unusually large number of inactive accounts. If the bank does not respond to a confirmation request, the auditor

should send a second request or ask the client to communicate with the bank to ask them to complete and return the confirmation to the auditor.

 **Receipt of a Cutoff Bank Statement** - A cutoff bank statement is a partial-period bank statement and the related copies of cancelled checks, duplicate deposit slips, and other documents included in bank statements, mailed by the bank directly to the CPA firm's office. The purpose of the cutoff bank statement is to verify the reconciling items on the client's year-end bank reconciliation with evidence that is not accessible to the client. To fulfill this purpose, the auditor requests the client to have the bank send the statement for 7 to 10 days subsequent to the balance sheet date directly to the auditor.

Many auditors verify the subsequent period bank statement if a cutoff statement is not received directly from the bank. The purpose is to test whether the client's employees have omitted, added, or altered any of the documents accompanying the statement. Obviously, this tests for intentional misstatements. The auditor performs the following verification in the month subsequent to the balance sheet date:

- Foot the lists of all cancelled checks, debit memos, deposits, and credit memos

- Verify that the bank statement balances when the footed totals are used

- Review the items included in the footings to make sure that they were cancelled by the bank in the proper period and do not include any erasures or alterations

 **Tests of the Bank Reconciliation** - A well-prepared independent bank reconciliation is an essential internal control over cash. Auditors test the bank reconciliation to determine whether client personnel have carefully prepared the bank reconciliation and to verify whether the client's recorded bank balance is the same amount as the actual cash in the bank except for deposits in transit, outstanding checks, and other reconciling items.

In verifying the reconciliation, the auditor uses information in the cutoff bank statement to verify the appropriateness of reconciling items. The auditor's verification of the reconciliation involves several procedures:

- Verify that the client's bank reconciliation is mathematically accurate.

- Trace the balance on the bank confirmation and/or the beginning balance on the cutoff statement to the balance per bank on the bank reconciliation to ensure they are the same.

Trace checks written and recorded before year-end and included with the cutoff bank statement to the list of outstanding checks on the bank reconciliation and to the cash disbursements journal in the period or periods prior to the balance sheet date. All checks that cleared the bank after the balance sheet date and were included in the cash disbursements journal should also be included on the outstanding check list. If a check was included in the cash disbursements journal, it should be included as an outstanding check if it did not clear before the balance sheet date. Similarly, if a check cleared the bank before the balance sheet date, it should not be on the bank reconciliation.

Investigate all significant checks included on the outstanding check list that have not cleared the bank on the cutoff statement. The first step in the investigation should be to trace the amount of any items not clearing to the cash disbursements journal. The reason for the check not being cashed should be discussed with the client, and if the auditor is concerned about the possibility of fraud, the vendor's accounts payable balance should be confirmed to determine whether the vendor has recognized the receipt of the cash in its records. In addition, a copy of the cancelled check should be examined before the last day of the audit if it becomes available.

Trace deposits in transit to the cutoff bank statement. All cash receipts not deposited in the bank at the end of the year should be traced to the cutoff bank statement to make sure that they were deposited shortly after the beginning of the new year.

Account for other reconciling items on the bank statement and bank reconciliation. These include such items as bank service charges, bank errors and corrections, and unrecorded transactions debited or credited directly to the bank account by the bank. These reconciling items should be investigated to be sure that they have been treated properly by the client.

QUICK CHECK

2.8. Fraud-oriented procedures

2. Why is the monthly reconciliation of bank accounts by an independent person

A major consideration in an important internal audit of control the general over cash balance balances? is the Which possibility in individuals of fraud will The

generally not be considered independent for this responsibility?
auditor must extend the procedures in the audit of year -end cash to deter - mine the possibility of

a material fraud when there are inadequate internal controls, especially the improper segregation of duties between the handling of cash and the recording of cash transactions in the accounting records and the lack of independently prepared monthly bank reconciliation.

In designing procedures for uncovering fraud, auditors should carefully consider the nature of the deficiencies in internal control, the type of fraud that is likely to result from the deficiencies, the potential materiality of the fraud, and the audit procedures that are most effective in uncovering the fraud.

When auditors are specifically testing for fraud, they should keep in mind that audit procedures other than tests of details of cash balances can also be useful. Procedures that may uncover fraud in the cash receipts area include:

- Confirmation of accounts receivable

- Tests performed to detect lapping

- Review of the general ledger entries in the cash account for unusual items

- Comparison of customer orders to sales and subsequent cash receipts

- Examination of approvals and supporting documentation for bad debts and sales returns and allowances

Similar tests can be used for testing for the possibility of fraudulent cash disbursements.

Extended Tests of the Bank Reconciliation

When the auditor believes that the year-end bank reconciliation may be intentionally misstated, it is appropriate to perform extended tests of the year-end bank reconciliation. The extended procedures verify whether all transactions included in the journals for the last month of the year were correctly included in or excluded from the bank reconciliation and verify whether all items in the bank reconciliation were correctly included. Let's assume that there are material internal control weaknesses and the client's year-end is December 31. Using a common approach, auditors:

1. Start with the bank reconciliation for November and compare all reconciling items with cancelled checks and other documents in the December bank statement.
2. Compare all remaining cancelled checks and deposit slips in the December bank statement with the December cash disbursements and receipts journals.

3. Trace all uncleared items in the November bank reconciliation and the December cash disbursements and receipts journals to the client's December 31 bank reconciliation to make sure they are included.
4. Verify that all reconciling items in the December 31 bank reconciliation represent items from the November bank reconciliation and December's journals that have not yet cleared the bank.

In addition to these four tests, the auditor must carry out procedures subsequent to the end of the year with the use of the bank cutoff statement.

Proof of Cash

A proof of cash is used to reconcile the cash receipts and disbursements recorded on the client's books with the cash deposited into and disbursed from the client's bank account for a specific time period. Because the proof contains four columns, a proof of cash is commonly referred to as a ***four-column proof of cash***.

Auditors sometimes prepare a proof of cash when the client has material internal control weaknesses in cash. The auditor uses a proof of cash to determine whether the following were done:

- All recorded cash receipts were deposited
- All deposits in the bank were recorded in the accounting records
- All recorded cash disbursements were paid by the bank
- All amounts that were paid by the bank were recorded

A proof of cash includes the following four reconciliation tasks:

- 1 Reconcile the balance on the bank statement with the general ledger balance at the beginning of the proof-of-cash period.
- 2 Reconcile cash receipts deposited per the bank with receipts recorded in the cash receipts journal for a given period.
- 3 Reconcile electronic payments and cancelled checks clearing the bank with those recorded in the cash disbursements journal for a given period.

- 4 Reconcile the balance on the bank statement with the general ledger balance at the end of the proof-of-cash period.

Tests of Interbank Transfers

Embezzlers occasionally cover a theft of cash by a practice known as **kiting**: transferring money from one bank to another and incorrectly recording the transaction. Near the balance sheet date, a check is drawn on one bank account and immediately deposited in a second account for credit before the end of the accounting period. In making this transfer, the embezzler is careful to make sure that the check is deposited at a late enough date so that it does not clear the first bank until after the end of the period. If the interbank transfer is not recorded until after the balance sheet date, the amount of the transfer is recorded as an asset in both banks. Although there are other ways to commit this fraud, each involves increasing the bank balance to cover a shortage by the use of interbank transfers.

To test for kiting, as well as for unintentional errors in recording interbank transfers, auditors can list all interbank transfers made a few days before and after the balance sheet date and trace each to the accounting records for proper recording. There are several things that should be audited on the interbank transfer schedule which includes:

The accuracy of the information on the interbank transfer schedule should be verified.

The interbank transfers must be recorded in both the receiving and disbursing banks.

The date of the recording of the disbursements and receipts for each transfer must be in the same fiscal year.

Disbursements on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as outstanding checks.

Receipts on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as deposits in transit.



QUICK CHECK

1. Explain the purpose of a four-column proof of cash. List two types of misstatements it is meant to uncover.
2. Define the term kiting. Describe audit procedures that can be used to uncover each.

2.9. Auditing a Payroll or Branch Imprest Account

The audit of any imprest cash account such as payroll or a branch account follows the same basic audit steps discussed under the audit of the general cash account. The auditor obtains bank reconciliation, along with a standard bank confirmation and a cutoff bank statement. However, the audit testing is less extensive for two reasons.

First, the imprest balance in the account is generally not material. For example, an imprest payroll or branch account may contain a balance of only \$1,000 except for the short time after a payroll deposit and before the related payroll disbursements have cleared.

Second, the types of disbursements from the account are homogeneous. The checks are for similar types of transactions and for relatively small amounts. For example, there may be a limit on the size of an individual payroll check.

2.10. Audit of imprest petty cash

Petty cash is a unique account. Although it is often immaterial in amount, many auditors verify petty cash primarily because of the potential for embezzlement and the client's expectation that auditors will examine the account, even when the amount is immaterial.

Internal Controls over Petty Cash

The most important internal control for petty cash is the use of an imprest fund that is the responsibility of *one individual*. In addition, petty cash funds should not be mingled with other receipts, and the fund should be kept separate from all other activities. There should also be limits on the amount of any expenditure from petty cash, as well as on the total amount of the fund. The types of expenditures that can be made from petty cash transactions should be well defined by company policy.

When a disbursement is made from petty cash, adequate internal controls require a responsible official's approval on a pre-numbered petty cash form. The total of the actual cash and checks in

the fund, plus the total unreimbursed petty cash forms that represent expenditures, should equal the total amount of the petty cash fund stated in the general ledger.

When the petty cash balance runs low, a check payable to the petty cash custodian should be written on the general cash account for the reimbursement of petty cash. The check should be for the exact amount of the pre-numbered vouchers that are submitted as evidence of actual expenditures. These vouchers should be verified by the accounts payable clerk and cancelled to prevent their reuse.

Audit Tests for Petty Cash

The emphasis in verifying petty cash should be on testing controls over petty cash transactions rather than the ending balance in the account. Even if the amount of the petty cash fund is small, the potential exists for numerous improper transactions if the fund is frequently reimbursed.

When control risk is assessed as low and few reimbursement payments occur during the year, it is common for auditors not to test petty cash, for reasons of immateriality. When auditors do test petty cash, the two most common procedures are to count the petty cash balance and to carry out detailed tests of one or two reimbursement transactions to determine that they are properly supported.

QUICK CHECK

1. Assume that a client with excellent internal controls uses an imprest payroll bank account. Explain why the verification of the payroll bank reconciliation ordinarily takes less time than the tests of the general bank account, even if the number of disbursements exceeds those for the general account.
2. Distinguish between the verification of petty cash reimbursements and the verification of the balance in the fund. Explain how each is done. Which is more important?

2.11. Segregation of duties

Segregation of duties with regard to control over cash includes the following types:

The custody (possessing), recording, and Authorization of cash should be separated. That is, the same person should not be entrusted to perform the two or three activities. The reason is that if the custody and record keeping are done by the same person, that person can steal money and they change the ledger to conceal the theft. If cashier has custody, the bookkeeper makes entries, and the finance head authorizes payments, this is good segregation of duty regarding to petty cash. If the Bank account is reconciled by one who does not have access to cash, then it is good segregation of duties regarding to cash in Bank the store keeper should not fill our receiving reports to control Inventory.

The person who authorizes salary for new employee should not be the one paying the salary.

The receiving of cash, depositing of the cash in the Bank, recording of cash and general ledger should be segregated.

Cash payment preparation, authorizing of cash payment, cash payment, (disbursing), and recording of cash payments in cash disbursement journal and general ledger such as Account payable ledger and cash control ledger should be segregated; that is each activity should be performed by different persons.

2.12. Limitations (weakness) of internal control over cash

Weak internal control procedures would create opportunity for fraud or defalcation /theft/ of cash. The most common defalcation techniques of cash are:

Withholding of cash receipts – proceeds from cash sales are withheld at point of sales recording and receiving of cash. For example, a cash register clerk can fail to register sales or under register amounts, and pocketing full or partial amounts. If the customer does not wait for his receipts and changes, or check amounts charged, registered, and paid.

Lapping - refers to cash collection on account from credit customer may be postponed (delayed). This is usually practiced as temporary borrowing, but in the long run they lead to cover up by more elaborate means. This is possible if a single person is responsible to receive cash from charge customers and keep records for accounts receivable at the same time.

Sales discount – cash can be abstracted from sales discount not taken by customers. i.e when customers pay the full amount, only amount net of discount are recorded to customers and the difference would be pocketed by recording it to discount account.

Writing off bad debts – Accounts Receivable could be written off as bad debts when actually customers' remittance is pocketed.

Fictions Accounts Receivable – Goods could be taken for private use or stolen by charging fictions customers and writing off as bad debts later on.

Check – kiting – It refers to transferring of check from one bank to another when business has two bank accounts say in bank X and Y check is written to withdraw an account from bank X account balance, and deposited into Bank Y account. Because of lag (delay) of time for clearance, the amount deposited in bank Y is immediately reflected, but is not reflected as deduction (withdrawal) from Bank X account soon, Consequently such technique is practiced by cashier to cover up cash shortage which an auditor might uncover.

Window – Dressing – Cash Shortage or cash position could be improved by holding the cash book open /unclosed) beyond the closing date to include subsequent cash receipts.

Others include – as cashier payable to self, check payable to others, petty cash vouchers.

QUICK CHECK

1. Discuss the limitations (weakness) of internal control over cash.
1. Discuss the segregation of duties with regard to control over cash.

2.13. Audit program for cash

The following audit program indicates the general pattern of work performed by the auditors in the verification of cash.

- A *Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.*
- B **Obtain an understanding of internal control over cash:** By understanding internal control over cash receipts and cash disbursements helps auditors to observe whether there

is appropriate segregation of duties and to enquire who performed various functions throughout the year.

- C ***Assess control risk and design additional tests of controls for cash:*** After obtaining an understanding of the client's internal control for cash receipts and disbursements, the auditors perform their initial assessment of control risk.
- D ***Perform additional tests of control for those controls, which the auditors plan to consider in their assessment of control risk:*** Tests directed toward the effectiveness of control help to evaluate the client's internal control and determine the extent to which the auditors are justified in reducing the assessed levels of control risk for assertions about the cash account. The following are examples of typical tests of controls.

Test the accounting records and reconciliation by re-performance.

Compare the detail of a sample of recorded disbursements in cash payments journal to accounts payable postings, purchase orders, receiving reports, invoices, and paid checks.

Compare the detail of a sample of recorded cash receipts listings to the cash receipts, journal, accounts receivable postings, and authenticated deposit slips.

- E. ***Reassess control risk and design substantive tests for cash:*** When the auditors have completed the procedures described above, they should reassess control risk and design substantive tests of cash transactions and balances.
- F. ***Perform further audit procedures—substantive procedures for cash transactions and balances.***
- 1 Obtain analyses of cash balances and reconcile them to the general ledger.
 - 2 Confirm cash balances with financial institutions.
 - 3 Obtain or prepare reconciliations of bank (financial institution) accounts as of the balance sheet date and consider the need to reconcile bank activity for additional months.
 - 4 Obtain a cutoff bank statement containing transactions of at least seven business days subsequent to balance sheet date.
 - 5 Count and list cash on hand.
 - 6 Verify the client's cutoff of cash receipts and cash disbursements.

- 7 Analyze bank transfers for the last week of audit year and the first week of following year.
- 8 Investigate any checks representing large or unusual payments to related parties.
- 9 Evaluate proper financial statement presentation and disclosure of cash.

G. Substantive tests:

Study and evaluate the adequacy of internal controls relating to cash balances on hand.

Audit procedures undertaken in connection with the recording of transaction in the cash book concerning sales, purchases, wages etc. form an integral part of the overall audit work undertaken. These procedures have an important bearing on the verification of the completeness of cash balances on hand. The work already undertaken need not repeated.

Ascertain cash balances on hand by undertaking physical verification of these balances. It is always advisable to do this without giving any prior information.

Surprise cash counts will avoid the possibility of the custodians making up any shortfall in the balances temporarily to satisfy the audit. For the very same reason it would be advisable to undertake and counts at the end of the accounting period and again at a alter date, reconciling the difference during the intervening period by vouching the transactions that took place during intervening period.

In case difference cash balances exist, undertake counting all of the simultaneously so as to avoid the possibility of making up any shortfall in one balance by transferring from another one.

Scrutinize a sample of cash receipts and payments towards the end of the current accounting period and the beginning of the next accounting period so as to make sure they are included in the correct accounting period.

Obtain confirmation from a responsible official independent of the cash department is respect of withdraws slips, IOUs, etc, include din cash balances (e.g. temporary advances paid to the client staff). Ensure that they are debited to the appropriate accounts.

Examine documentary evidence in support of cash in transit, cash with branches, and cash with agents, etc. and verify their subsequent receipt.

Ensure that any foreign currencies are converted at the appropriate authoritative rates. Check the calculations.

Summary

In this chapter, we have seen that transactions in most cycles affect the cash account. Because of the relationship between transactions in several cycles and the ending cash account balance, the auditor typically waits to audit the ending cash balance until the results of tests of controls and substantive tests of transactions for all cycles are completed and analyzed. Tests of the cash balance normally include tests of the bank reconciliations of key cash accounts, such as the general cash account, imprest payroll account, and imprest petty cash fund. If auditors assess a high likelihood of fraud in cash, they may perform additional tests such as extended bank reconciliation procedures, a proof of cash, or tests of interbank transfers.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question

1. Which statement is false about Existence of account receivable?
 - A. Recorded accounts receivable exist.
 - B. Existing accounts receivable are included.
 - C. Accounts receivable are accurate.
 - D. Accounts receivable are correctly classified.
 - E. Cutoff for accounts receivable is correct.
 - F. None of the above
2. Proper segregation of functional responsibilities calls for separation of the
 - A. Authorization, approval and execution functions.
 - B. Authorization, execution and payment functions.
 - C. Receiving, shipping and custodial functions.
 - D. Authorization, recording and custodial functions.
 - E. None of the above
3. On receiving the bank cutoff statement, the auditor should trace
 - A. Deposits in transit on the year-end bank reconciliation to deposits in the cash receipts journal.
 - B. Checks dated prior to year-end to the outstanding checks listed on the yearend bank reconciliation.
 - C. Deposits listed on the cutoff statement to deposits in the cash receipts journal.
 - D. Checks dated subsequent to year-end to the outstanding checks listed on the year-end bank reconciliation.
 - E. None of the above

4. Which of the following is the objective of major substantive tests of cash transactions and balance?
 - A. Clerical accuracy.
 - B. Existence and ownership.
 - C. Completeness.
 - D. All of the above.
5. An auditor ordinarily should send a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balance, because this procedure
 - A. Provides for confirmation regarding compensating balance arrangements.
 - B. Detects kiting activities that may otherwise not be discovered.
 - C. Seeks information about indebtedness to the bank.
 - D. Verifies securities held by the bank in safekeeping.
 - E. None of the above

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Evaluate the necessity of following the practice described by an auditor: “In confirming bank accounts, I insist upon a response from every bank the client has done business with in the past 2 years, even though the account may be closed at the balance sheet date.”
2. Describe what is meant by a cutoff bank statement and state its purpose.
3. Why are auditors usually less concerned about the client’s cash receipts cutoff than the cutoff for sales? Explain the procedure involved in testing for the cutoff for cash receipts.
4. When the auditor fails to obtain a cutoff bank statement, it is common to verify the entire statement for the month subsequent to the balance sheet date. How is this done and what is its purpose?

5. Explain why, in verifying bank reconciliations, most auditors emphasize the possibility of a nonexistent deposit in transit being included in the reconciliation and an outstanding check being omitted rather than the omission of a deposit in transit and the inclusion of a nonexistent outstanding check.
6. How will a company's bank reconciliation reflect an electronic deposit of cash received by the bank from credit card agencies making payments on behalf of customers purchasing products from the company's online Web site, but not recorded in the company's records?
7. Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash receipts, and the tests of details of cash balances.
8. Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash disbursements, and the tests of details of cash balances. Give one example in which the conclusions reached about internal controls in cash disbursements will affect the tests of cash balances.
9. Evaluate the effectiveness and state the shortcomings of the preparation of a bank reconciliation by the controller in the manner described in the following statement: "When I reconcile the bank account, the first thing I do is review the sorted list of returned checks and find which numbers are missing. Next I determine the amount of the uncleared checks by referring to the cash disbursements journal. If the bank account reconciles at that point, I am all finished with the reconciliation. If it does not, I search for deposits in transit, checks from the beginning outstanding check list that still have not cleared, other reconciling items, and bank errors until it reconciles. In most instances, I can do the reconciliation in 20 minutes."
10. Assume that a client with excellent internal controls uses an imprest payroll bank account. Explain why the verification of the payroll bank reconciliation ordinarily takes less time than the tests of the general bank account, even if the number of disbursements exceeds those for the general account.
11. Distinguish between the verification of petty cash reimbursements and the verification of the balance in the fund. Explain how each is done. Which is more important?

CHAPTER THREE

AUDIT OF RECEIVABLES AND SALES

3.0. Learning objectives

At the end of this chapter, learners should be able to:

Explain the nature of sales and collection of receivables.

Identify the accounts and the classes of transactions in the sales and collection cycle.

Describe the business functions and the related documents and records in the sales and collection cycle.

Understand internal control, and design and perform tests of controls and substantive tests of transactions for sales.

Describe the auditors' objectives for the audit of receivables and sales.

Describe the nature of the audit procedures to accomplish the auditors' objectives for the audit of receivables and sales.

3.1. Introduction

Dear student, this chapter is second chapter for the entire course. It is basically designed to examines the audit of sales/revenue and receivables. You should bear in mind in the audit of receivables that receivables are a product of the sales cycle and therefore the control objectives of the sales cycle are relevant. Receivable is a general term that may refer to many types of receivables whose origin and nature may be different. Because a considerable portion of the audit of transactions in the sales and collection cycle involves documents and records, it is essential to understand the typical documents and records used in the cycle which will be discussed in this chapter.

3.2. Sources and nature of receivable

The sales and collection cycle including the receiving of orders from customers are delivery and billing of merchandise to customers, and the recording and collection of receivables. Receivables from customers include both accounts receivable and various types of notes

receivable. It is important to differentiate the origin and nature of receivables to ensure their appropriate classification and valuation.

The source of account receivables includes the following:

- Claims against customers from sale of goods
- Loans to officers or employees
- Loans to subsidiaries
- Claims against various other refunds
- Claims for tax refunds
- Advances to suppliers

3.3. Accounts and classes of transactions in the sales and collection cycle

The overall objective in the audit of the sales and collection cycle is to evaluate whether the account balances affected by the cycle are fairly presented in accordance with accounting standards. In general there are five **classes of transactions in the sales and collection cycle**. The nature of the accounts may vary, of course, depending on the industry and client involved. There are differences in the nature and account titles for a service industry, a retail company, and an insurance company, but the key concepts remain the same. To provide a frame of reference for understanding the material in this chapter, let's assume we're dealing with a wholesale merchandising company.

The five classes of transactions in the sales and collection cycle includes the following:

1. Sales (cash and sales on account)
2. Cash receipts
3. Sales returns and allowances
4. Write-off of uncollectible accounts
5. Estimate of bad debt expense

In the above five class of transaction one can understand that, with the exception of cash sales, every transaction and amount is ultimately included in one of two balance sheet accounts, accounts receivable or allowance for uncollectible accounts. For simplicity, we assume that the same internal controls exist for both cash and credit sales.

QUICK CHECK

1. List the source of account receivables.
2. Discuss the five classes of transactions in the sales and collection cycle.

3.4. Business functions in the cycle and related documents and records

The **sales and collection cycle** involves the decisions and processes necessary for the transfer of the ownership of goods and services to customers after they are made available for sale. It begins with a request by a customer and ends with the conversion of material or service into an account receivable, and ultimately into cash.

Table 3.1. Classes of Transactions, Accounts, Business Functions, and Related Documents and Records for the Sales and Collection Cycle

Classes of Transactions	Accounts	Business Functions	Documents and Records
Sales	Sales Accounts receivable	Processing customer orders Granting credit Shipping goods Billing customers and recording sales	Customer order Sales order order or sales order Shipping document and recording sales Sales transaction file Sales journal or listing Accounts receivable master file Accounts receivable trial balance Monthly statement
Cash receipts	Cash in bank (debits from cash receipts) Accounts receivable	Processing and recording cash receipts	Remittance advice Prelisting of cash receipts Cash receipts transaction file Cash receipts journal or listing
Sales returns and allowances	Sales returns and allowances Accounts receivable	Processing and recording sales returns and allowances	Credit memo Sales returns and allowances journal
Write-off of uncollectible accounts	Accounts receivable Allowance for uncollectible accounts	Writing off uncollectible accounts receivable	Uncollectible account authorization form General journal
Bad debt expense	Bad debt expense	Providing for bad	General journal

	Allowance for uncollectible accounts	debts	

3.5. Control objectives and Test of controls

The following control objectives and Test of controls are applicable in the accounts Receivable and sales (Revenue) Transaction.

Validity – the validity internal control objectives relates to management’s assertion about existence or occurrence. Auditors are concerned about the validity objective for revenue from actions because clients are more likely to overstate sales than to understate them. The possible misstatement including sells to fictitious customer, and recording of revenue when goods have not been shipped or services have not been performed. The major control for preventing such misstatement is segregation of duties between the shipping function and the order entry and billing function. Requiring an approved customer sales order and shipping document before revenue is recognized also minimizes the recording of fictions sales in client’s records.

Completeness – the completeness objective relates to the completeness assertion. The major misstatement that concerns both management and Auditor is that goods are shipped or services are performed and no revenue is recognized control procedures that provide assurance that accounting for numerical sequences of shipping documents and sales invoices, matching shipping documents with sales invoices, reconciling the sales invoices to daily sales report, and minting and reviewing the open –order file.

Timeliness – timeliness internal control objective relates to the completeness assertion. After client does not have adequate controls to ensure that revenue transaction recorded on timely basis, sales may be recorded in the wrong accounting period. The client should require that all shipping documents be forwarded to the billing function daily for processing on a timely basis. The Auditor should test this control by comparing the date on a bill of lading with the date on the respective sales invoice and the date the sales invoice was recorded in the sales journal. All billing must occur with the minimum delay.

Authorization of revenue Transaction - this internal control objective relates to the valuation assertion’ possible misstatements due to improper authorization include

shipping goods to or performing services for customers who are bad credit risks and making sales at unauthorized prices or terms. Authorized price lists and specified terms of trade, for shipping and credit must be established. The auditor is concerned about authorization at *three key points*:

1. Credit must be properly authorized before a sale takes place.
2. Goods should be shipped only after proper authorization.
3. Prices, including basic terms, freight, and discounts, must be authorized.

The first two controls are meant to prevent the loss of company assets by shipping to fictitious customers or those who will fail to pay for the goods. Price authorization is meant to ensure that the sale is billed at the price set by company policy. Authorization may be done for each individual transaction or general authorization may be given for specific classes of transactions. General authorizations are often done automatically by computer.

Valuation – This control relates to valuation assertion – Incorrectly valued (determined) amount of Revenue results in misstatements that directly affect amounts reported in financial statements there must be authorized price, terms of trade, type of goods shipped, and a sale invoices should be verified for mathematical accuracy before being sent. To recording.

Adequate Documents and Records Because each company has a unique system of originating, processing, and recording transactions, auditors may find it difficult to evaluate whether each client's procedures are designed for maximum control. Nevertheless, adequate record-keeping procedures must exist before most of the transaction related audit objectives can be met. Some companies, for example, automatically prepare a multi-copy pre-numbered sales invoice at the time a customer order is received. Copies of this document are used to approve credit, authorize shipment, record the number of units shipped, and bill customers. This system greatly reduces the chance of the failure to bill a customer if all invoices are accounted for periodically, but controls have to exist to ensure the sale isn't recorded until shipment occurs. Under a system in which the sales invoice is prepared only after a shipment has been made, the likelihood of failure to bill a customer is high unless some compensating control exists.

In many organizations, all sales documents are electronic and no paper documents are prepared.

Pre-numbered Documents - Prenumbering is meant to prevent both the *failure* to bill or record sales and the occurrence of *duplicate* billings and recordings. Of course, it does not do much good to have prenumbered documents unless they are properly accounted for. To use this control effectively, a billing clerk will file a copy of all shipping documents in sequential order after each shipment is billed, while someone else will periodically account for all numbers and investigate the reason for any missing documents.

Monthly Statements - Sending monthly statements is a useful control because it encourages customers to respond if the balance is incorrectly stated. These statements should be controlled by persons who have no responsibility for handling cash or recording sales or accounts receivable to avoid the intentional failure to send the statements. For maximum effectiveness, all disagreements about the account balance should be directed to a designated person who has no responsibility for handling cash or recording sales or accounts receivable.

Internal Verification Procedures - Computer programs or independent personnel should check that the processing and recording of sales transactions fulfill each of the six transaction-related audit objectives. Examples include accounting for the numerical sequence of prenumbered documents, checking the accuracy of document preparation, and reviewing reports for unusual or incorrect items.

Classification of Revenue Transaction - This control objective relates to the presentation and disclosure assertion – the use of chart of accounts and proper codes for recording transactions should provide adequate assurance about the objective. The auditor can review the sales journal and general ledger for proper classification.

Posting and summarization of revenue - This Internal control objective relates to the presentation and disclosure assertion. There is possibility that transactions are not properly summarized from source documents or posted properly from journal to subsidiary and general ledgers. Therefore, the control test should include as, reconciling sales invoices to the daily sales report (summary report) and the daily recordings in sales

journal should be reconciled with the posting to the accounts receivable subsidiary ledger, this ledger should periodically be reconciled to the general ledger control account.

Adequate Separation of Duties - Proper separation of duties helps prevent various types of misstatements due to both errors and fraud. To prevent fraud, management should deny cash access to anyone responsible for entering sales and cash receipts transaction information into the computer. The credit-granting function should be separated from the sales function, because credit checks are intended to offset the natural tendency of sales personnel to optimize volume even at the expense of high bad debt write-offs. Personnel responsible for doing internal comparisons should be independent of those entering the original data.

For example, comparison of batch control totals with summary reports and comparison of accounts receivable master file totals with the general ledger balance should be done by someone independent of those who input sales and cash receipt transactions.

QUICK CHECK

3. Discuss the control objectives and Test of controls that are applicable in the accounts Receivable and sales (Revenue) Transaction.

3.6. Documents in the Sale cycle

The table below can be used to familiarize you with the documents in the cycle when studying this chapter. We are especially interested in controls associated with each document.

Table 3.2. Documents in Sales Cycle

Document	Controls (objective)	Comments
Customer order		Process is initiated with the customer order. The customer order is not primary for the existence assertion (shipping document is). Order could be received by mail, phone, over the internet, or through EDI.

Document	Controls (objective)	Comments
Sales order	Credit approval and authorization of shipment (occurrence).	Sales orders should receive approval prior to shipment, including authorization of credit (specific or general). Credit should be authorized by someone <i>independent of sales</i> (often done automatically by computer). ⁽¹⁾ Credit approval process affects extent of netrealizable value tests (test of allowance for doubtful accounts).
Continued in the next page		
Shipping document (bill of lading)	Checking of quantities (accuracy). Account for sequence (completeness).	Shipper is primary evidence of occurrence , because all recorded sales should be supported by a shipper. Account for numerical sequence to ensure completeness (all shippers should result in a sales invoice).
Sales invoice	Matched with shipper (occurrence). Prices, quantities and extensions checked (accuracy). Account for sequence (completeness).	The sales invoice is the main document for the recording of sales. Accounting for the sequence of sales invoices in the sales journal also assures completeness by determining that all sales were recorded. ⁽²⁾
Sales journal	Footings and postings checked (posting and summarization). Posted as soon as possible after goods are shipped (timeliness).	Sales invoices are recorded in the sales journal. Posted to the G/L, usually monthly. With computerized system, individual entries should also be posted automatically to the A/R sub ledger.
Credit Memo	Proper approval (occurrence). Receiving report for returned goods (occurrence).	Source document for returns and allowances. Returns should be supported by a receiving report; other allowances should be properly authorized. Testing depends upon materiality of amounts.
Cash receipt prelist	Prepared by someone independent of accounts	Beginning of cash receipts cycle, and point where cash enters business.

Document	Controls (objective)	Comments
	receivable, often an administrative assistant or someone with no accounting duties (completeness).	Establishes record of cash received to prevent theft. Checks should also be restrictively endorsed at this point. This assumes payment by mail, usually in the form of a check. Checks can also be sent directly to a lockbox, or wire transferred. Different controls are necessary for firms that receive payments in cash.
Continued in the next page		
Remittance advice	Document that accompanies payment by check - often the lower portion of the check (completeness and accuracy). The remittance advice is also important evidence of the occurrence of a cash receipt because the other evidence (the check) is deposited. The actual cash receipts should be deposited - usually on a daily basis (timeliness)	Additional evidence of amount of cash received. When no remittance advice is received, it is customary for the person who prelists cash to prepare one.
Cash receipts journal	Posting and summarization checked (P&S). CR recorded at time of receipt (timeliness)	The cash receipts journal is used to record individual cash receipts. Individual cash receipts are automatically posted by computer to individual customer A/R.
Accounts receivable sub ledger	Reconciled to the general ledger by someone independent of sales and cash receipts (posting and summarization , as well as other objectives)	The accounts receivable sub ledger is important because it is the interface between the sales and cash receipts cycle. The reconciliation of the sub ledger to the general ledger is an important control.
Bad debt charge-off	Should be authorized (occurrence)	Company should have proper procedures to charge-off accounts. Should be authorized by

Document	Controls (objective)	Comments
		someone independent of authorization of credit and recording of sales.

3.7. Steps and procedures in Sales and Collection Cycle

Sale involves a series of steps and procedures. At this point it is important to discuss the steps and procedures that sales involve. This procedure includes the following seven steps and procedure which will be discussed as follows:

1. Processing Customer Orders

A customer's request for goods initiates the entire cycle. Legally, it is an offer to buy goods under specified terms. The receipt of a customer order often results in the immediate creation of a sales order.

 **Customer Order** - A customer order is a request for merchandise by a customer. It may be received by telephone, letter, a printed form that has been sent to prospective and existing customers, through salespeople, electronic submission of the customer order through the Internet, or other network linkage between the supplier and the customer.

 **Sales Order** - A sales order is a document for communicating the description, quantity, and related information for goods ordered by a customer. This is often used to indicate credit approval and authorization for shipment.

2. Granting Credit

Before goods are shipped, a properly authorized person must *approve credit* to the customer for sales on account. Weak practices in credit approval often result in excessive bad debts and accounts receivable that may be uncollectible. An indication of credit approval on the sales order often serves as the approval to ship the goods. In some companies, the computer automatically approves a credit sale based on preapproved credit limits maintained in a customer master file. The computer allows the sale to proceed only when the proposed sales order total plus the existing customer balance is less than the credit limit in the master file.

3. Shipping Goods

This critical function is the first point in the cycle at which the company gives up assets. Most companies recognize sales when goods are shipped. A shipping document is prepared at the time of shipment, which can be done automatically by a computer, based on sales order information. The shipping document, which is often a multicopy bill of lading, is essential to the proper billing of shipments to customers. Companies that maintain perpetual inventory records also update them based on shipping records.

Shipping Document - A shipping document is prepared to initiate shipment of the goods, indicating the description of the merchandise, the quantity shipped, and other relevant data. The company sends the original to the customer and retains one or more copies. The shipping document serves as a signal to bill the customer and may be in electronic or paper form.

4. Billing Customers and Recording Sales

Because billing customers is the means by which the customer is informed of the amount due for the goods, it must be done correctly and on a timely basis. The most important aspects of billing are:

All shipments made have been billed (completeness)

No shipment has been billed more than once (occurrence)

Each one is billed for the proper amount (accuracy)

Billing the proper amount is dependent on charging the customer for the quantity shipped at the authorized price, which includes consideration for freight charges, insurance, and terms of payments.

Sales Invoice - A sales invoice is a document or electronic record indicating the description and quantity of goods sold, the price, freight charges, insurance, terms, and other relevant data. The sales invoice is the method of indicating to the customer the amount of a sale and the payment due date. Companies send the original to the customer, and retain one or more copies.

Sales Transaction File - This is a computer-generated file that includes all sales transactions processed by the accounting system for a period, which could be a day,

week, or month. It includes all information entered into the system and information for each transaction, such as customer name, date, amount, account classification or classifications, salesperson, and commission rate. The file can also include returns and allowances or there can be a separate file for those transactions. The information in the sales transaction file is used for a variety of records, listings, or reports, depending on the company's needs. These may include a sales journal, accounts receivable master file, and transactions for a certain account balance or division.

Sales Journal or Listing - This is a listing or report generated from the sales transaction file that typically includes the customer name, date, amount, and account classification or classifications for each transaction, such as division or product line. It also identifies whether the sale was for cash or accounts receivable. The journal or listing is usually for a month but can cover any period of time. Typically, the journal or listing includes totals of every account number for the time period. The same transactions included in the journal or listing are also posted simultaneously to the general ledger and, if they are on account, to the accounts receivable master file. The journal or listing can also include returns and allowances or there can be a separate journal or listing of those transactions.

Accounts Receivable Master File - This is a computer file used to record individual sales, cash receipts, and sales returns and allowances for each customer and to maintain customer account balances. The master file is updated from the sales, sales returns and allowances, and cash receipts computer transaction files. The total of the individual account balances in the master file equals the total balance of accounts receivable in the general ledger. A printout of the accounts receivable master file shows, by customer, the beginning balance in accounts receivable, each sales transaction, sales returns and allowances, cash receipts, and the ending balance.

Accounts Receivable Trial Balance - This list or report shows the amount receivable from each customer at a point in time. It is prepared directly from the accounts receivable master file, and is usually an *aged* trial balance that includes the total balance outstanding and the number of days the receivable has been outstanding, by category of days (such as less than 30 days, 31 to 60 days and so on).

Monthly Statement - This is a document sent by mail or electronically to each customer indicating the beginning balance of their accounts receivable, the amount and date of

each sale, cash payments received, credit memos issued, and the ending balance due. It is, in essence, a copy of the customer's portion of the accounts receivable master file.

5. Processing and Recording Cash Receipts

The four sales transaction functions are necessary for getting the goods into the hands of customers, correctly billing them, and reflecting the information in the accounting records. The remaining four functions involve the collection and recording of cash, sales returns and allowances, write-off of uncollectible accounts, and providing for bad debt expense.

Remittance Advice - A remittance advice is a document mailed to the customer and typically returned to the seller with the cash payment. It indicates the customer name, the sales invoice number, and the amount of the invoice. A remittance advice is used as a record of the cash received to permit the immediate deposit of cash and to improve control over the custody of assets. If the customer fails to include the remittance advice with the payment, it is common for the person opening the mail to prepare one at that time.

Prelisting of Cash Receipts - This is a list prepared when cash is received by someone who has no responsibility for recording sales, accounts receivable, or cash, and who has no access to accounting records. It is used to verify whether cash received was recorded and deposited at the correct amounts and on a timely basis.

Cash Receipts Transaction File - This is a computer-generated file that includes all cash receipts transactions processed by the accounting system for a period, such as a day, week, or month. It includes the same type of information as the sales transaction file.

Cash Receipts Journal or Listing - This listing or report is generated from the cash receipts transaction file and includes all transactions for a time period. The same transactions, including all relevant information, are included in the accounts receivable master file and general ledger.

6. Processing and Recording Sales Returns and Allowances

When a customer is dissatisfied with the goods, the seller often accepts the return of the goods or grants a reduction in the charges. The company prepares a receiving report for returned goods and returns them to storage. Returns and allowances are recorded in the sales returns and

allowances transaction file, as well as the accounts receivable master file. Credit memos are issued for returns and allowances to aid in maintaining control and to facilitate record keeping.

Credit Memo - A credit memo indicates a reduction in the amount due from a customer because of returned goods or an allowance. It often takes the same general form as a sales invoice, but it supports reductions in accounts receivable rather than increases.

Sales Returns and Allowances Journal - This is the journal used to record sales returns and allowances. It performs the same function as the sales journal. Many companies record these transactions in the sales journal rather than in a separate journal.

7. Writing Off Uncollectible Accounts Receivable

Regardless of the diligence of credit departments, some customers do not pay their bills. After concluding that an amount cannot be collected, the company must write it off. Typically, this occurs after a customer files for bankruptcy or the account is turned over to a collection agency. Proper accounting requires an adjustment for these uncollectible accounts.

Uncollectible Account Authorization Form - This is a document used internally to indicate authority to write an account receivable off as uncollectible.

8. Providing for Bad Debts

Because companies cannot expect to collect on 100% of their sales, accounting principles require them to record bad debt expense for the amount they do not expect to collect. Most companies record this transaction at the end of each month or quarter.

QUICK CHECK

4. Describe the nature of the following documents and records and explain their use in the sales and collection cycle: bill of lading, sales invoice, credit memo, remittance advice, monthly statement to customers.

3.8. Objectives for the Audit of Receivables and Revenue

The audit objectives for the receivables and sales relate to obtain to sufficient competent evidence about each significant financial statement assertion that pertains receivables and sales transactions and balances. To achieve each of these specific audit objectives, the auditors employ various parts of the audit planning and audit testing methodology.

The auditors' objectives in the examination of receivables and sales are:

1. To consider internal control over receivables and sales transactions.
2. To determine the existence of receivables, the clients ownership of these assets, and the occurrence of sales transactions.
3. To establish the completeness of receivables and sales transactions.
4. To establish the clerical accuracy of records and supporting schedules of receivables and sales.
5. To determine that the valuation of receivables is at appropriate net realizable values.
6. To determine that the statement presentation of receivables and sales is adequate.

Table 2.2 Selected specific audit objectives for receivables and sales

Assertion Category	Transaction class	Audit objective
Existence or Occurrence	Recorded sales transactions represent goods shipped during the period. Recorded cash receipts transactions represent cash received during the period.	Accounts receivable include all amounts owed by the customers exists at the balance sheet date.
Completeness	All sales, cash receipts sales adjustments that occurred during the period have been recorded.	Accounts receivable include all claims on customers at the balance sheet date.
Rights and Obligations	The entity has rights to the receivables and cash resulting from sales transactions.	Accounts receivable at the balance sheet date represents legal claims of the entity.
Valuation	All sales, cash receipts and sales adjustments transactions are correctly journalized, summarized, and posted.	Accounts receivable represent gross claims, On customers at the balance sheet date. The allowance for uncollectible accounts represents a reasonable estimate.
Presentation ad	The details of sales, cash receipts and	Accounts receivables are properly

disclosure	sales adjustments support their presentation in the financial statements.	identified and classified.

3.9. Internal Control over Account Receivable and Revenue/Sale

The objectives of internal controls over receivables are to ensure:

All goods dispatched are invoiced.

Invoicing is at correct price and discount.

Goods are only dispatched on credit to approved customers.

Invoices are recorded and related to subsequent cash receipts. Receivables are controlled and bad debts pursued.

Credit notes approved.

In addition the internal control over receivables should be such that the possibility of any falsification of the receivables accounts is eliminated. An important part of the controls would be to ensure that the cashier does not have access to the sales ledger, and the sales ledger clerk does not have access to cash received. Control procedures, over sales and receivables include the following.

Orders:

-  The orders should be checked against the customer's account.
-  All orders received should be recorded on pre – numbered sales order documents.
-  All orders should be authorized before goods are dispatched.

Dispatch:

-  Dispatch notes should be pre - numbered and a register kept of them to relate to sales invoices and orders.
-  Goods dispatch notes should be authorized as goods leave.

Invoicing:

-  Sales invoices should be authorized by a responsible official.
-  Sales invoices should be checked for prices and calculations by a person other than the one preparing the invoice.
-  All invoices should be pre – numbered consecutively.
-  Copies of cancelled invoices should be retained.

Receivables:

- ✚ A receivable ledger control account should be prepared and checked to individual sales ledger balances.
- ✚ Receivables ledger personnel should be independent of dispatch and cash receipt functions.
- ✚ Statements should be sent regularly to customers.

Bad debts:

- ✚ The authority to write off a bad debt should be given in writing and adjustments made to the accounts receivable ledger.
- ✚ The use of court action or write – off of a bad debt should be authorized by an official independent of the cash receipts function.

QUICK CHECK

6. What are the auditors' objectives in the examination of receivables and sales?

3.9.1. Revenue Cycle Controls

The revenue/sales cycle control includes the following points:

Segregation of duties--sales and collections

Matching of sales invoices and shipping documents

Clerical accuracy checks on invoices

Credit approval for sales transactions

Mailing of monthly statements

Reconciliation of bank accounts

Use of control listing of cash receipts Use

of budgets and analysis of variances

Control over shipping and billing documents

Use of authorized credit memoranda

Use of chart of accounts and review of account coding

3.9.2. Audit program for receivables and sales transactions

The following audit procedures are typical of the work done in the verification of notes, accounts receivable, and sales transaction.

- A. ***Consider internal control for receivables and sales:*** Obtain an understanding of internal control for receivables and sales. How do auditors obtain an understanding of internal control? Using one typical approach for sales, auditors study the client's flowcharts, make inquiries of the client using an internal control questionnaire, and perform walkthrough tests of sales. The auditors' consideration of internal controls over receivables and sales may begin with the preparation of a written narrative or flow chart and the completion of an internal control questionnaire. As the auditors' confirm their understanding of the sales and collection cycle, they will observe whether there is appropriate segregation of duties, and enquire as to who performed various functions throughout the year.
- B. ***Use the understanding of the client and its environment:*** this is help to consider inherent risks, including fraud risks, related to receivables and revenue.
- C. ***Assess control risk and design additional tests of controls for receivables and sales:*** After obtain an understanding of the client's internal control for receivables and sales transactions, the auditors perform their initial assessment of control risk for the variant financial statement assertions. The auditor uses the information obtained in understanding internal control to assess control risk. Four steps are essential steps to this assessment.
 - 1. The auditor needs a framework for assessing control risk. The six transactions related audit objectives provide this framework. These six objectives are the same for every audit of sales.
 - 2. The auditor must identify the key internal controls and deficiencies for sales. These will differ for every audit because every client has different internal controls.
 - 3. After identifying the controls and deficiencies, the auditor associates them with the objectives.
 - 4. The auditor assesses control risk for each objective by evaluating the controls and deficiencies for each objective. This step is critical because it affects the auditor's

decisions about both tests of controls and substantive tests. It is a highly subjective decision.

- D. ***Perform additional tests and controls:*** Tests directed towards the effectiveness of control help to evaluate the client's internal control, and determine the extent to which the auditors are justified in reducing their assessed levels of control risk for the assertion about the receivables and sales accounts. The following are examples of additional tests:

Examine significant aspects of a sample of sales transactions.

Compare a sample of shipping documents to related sales invoices.

Review the use and authorization of credit memoranda.

Reconcile selected cash register tapes and sales invoices with sales journals. Reconcile selected cash register tapes and sales tickets with sales journals. Test IT application controls.

Examine evidence of review and approval of revenue estimates.

- E. ***Reassess control risk and design substantial tests:*** When auditors have completed the procedures described in the preceding sections, they should assess the extent of control risk for each financial statement assertions regarding receivables and sales transactions. The assessment will determine the nature, extent, and timing of auditors' substantive tests for receivables and sales.

- F. ***Perform further audit procedures:*** substantive procedures for receivables and revenue.

1. Obtain an aged trial balance of trade accounts receivable and analyses of other accounts receivable and reconcile to ledgers.
2. Obtain analyses of notes receivable and related interest.
3. Inspect notes on hand and confirm those with holders.
4. Confirm receivables with debtors.
5. Review the year-end cutoff of sales transactions.
6. Perform analytical procedures for accounts receivable, notes receivable, and revenue.
7. Review significant year-end sales contracts for unusual terms.
8. Test the valuation of notes receivable, computation of interest income, interest receivable, and amortization of discount or premium.
9. Evaluate the propriety of the client's accounting methods for receivables and revenue.
10. Evaluate accounting estimates related to revenue recognition.

11. Determine the adequacy of the client's allowance for uncollectible accounts.
12. Ascertain whether any receivables have been pledged.
13. Investigate any transactions with or receivables from related parties.
14. Evaluate the business purpose of significant and unusual sales transactions.
15. Evaluate financial statement presentation and disclosure of receivables and revenue.

Table 3.3. Illustrative Substantive Tests of Transactions

Objective	Procedure	Comment
Recorded sales exist (occurrence)	Trace from sales journal or invoice to shipper.	Almost always done, even if controls are effective.
Existing sales are recorded (completeness)	Trace from shippers to recorded sales (invoice or journal)	Probably not necessary if tested controls.
Sales are recorded at proper amounts (accuracy)	Recompute quantities and extensions (reperformance). Agree price to price list.	Normally done. Can reduce sample size if controls exist.
Sales are properly classified	Check documents supporting sale for proper account distribution in sales journal.	Not normally an important issue.
Sales are timely recorded	Compare dates on shipper with sales invoice and entry in sales journal	Really a test of control.
Sales are summarized	Foot sales journal and trace to entry in general ledger. Test reconciliation of A/R subledger to general ledger.	Generally always done.

QUICK CHECK

7. Discuss the audit procedures in the verification of notes, accounts receivable, and sales transaction.

3.10. Sales returns and allowances

The transaction-related audit objectives and the client's methods of controlling misstatements are essentially the same for processing credit memos as those described for sales, with two differences. The first is *materiality*. In many instances, sales returns and allowances are so immaterial the auditor can ignore them.

The second difference is *emphasis on the occurrence objective*. For sales returns and allowances, auditors usually emphasize testing recorded transactions to uncover any theft of cash from the collection of accounts receivable that was covered up by a fictitious sales return or allowance. (Although auditors usually emphasize the occurrence objective for sales returns and allowances transactions, the *completeness* objective is especially important in tests of account balances to determine if sales and returns are understated at year-end.)

Naturally, other objectives should not be ignored. But because the objectives and methodology for auditing sales returns and allowances are essentially the same as for sales, we do not include a detailed study of them. If you need to audit sales returns and allowances, you should be able to apply the same logic to arrive at suitable controls, tests of controls, and substantive tests of transactions to verify the amounts.

- ✚ **Recording** - theoretically should be matched with sale. In practice returns and allowances are recorded as they occur. This does not present a problem, if there are no significant returns after year-end.

- ✚ **Authorization** - Returned goods should be sent to the receiving department, and a **receiving report** prepared. Other allowances should be specifically authorized.

- ✚ **Objectives:**

 - Transactions** - focus is on the ***occurrence*** of returns and allowances since they *can be used to hide theft of cash*.

 - Balances** - In the year-end tests of accounts receivable, the focus is on ***completeness***, since the failure to record returns overstates accounts receivable.

The significance of sales returns and allowances determines the extent to which they are tested.

3.11. Audit tests for the write-off of uncollectible accounts

The same as for sales returns and allowances, the auditor's primary concern in the audit of the write-off of uncollectible accounts receivable is the possibility of client personnel covering up an embezzlement by writing off accounts receivable that have already been collected (the occurrence transaction-related audit objective). The major control for preventing this fraud is proper authorization of the write-off of uncollectible accounts by a designated level of management only after a thorough investigation of the reason the customer has not paid.

Normally, verification of the accounts written off takes relatively little time. Typically, the auditor examines approvals by the appropriate persons. For a sample of accounts written off, it is also usually necessary for the auditor to examine correspondence in the client's files establishing their uncollectibility. In some cases, the auditor also examines credit reports. After the auditor has concluded that the accounts written off by general journal entries are proper, selected items should be traced to the accounts receivable master file to test whether the write-off was properly recorded.

The estimation of bad debt expense, which is the fifth class of transactions in the sales and collection cycle, obviously relates to the write-off of uncollectible accounts. However, because the estimation of bad debts is based on the year-end accounts receivable balances, the auditor evaluates the estimate for uncollectible accounts as part of the tests of details of ending accounts receivable balances.

Summary

This chapter deals with designing tests of controls and substantive tests of transactions for each of the five classes of transactions in the sales and collection cycle, including sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts receivable, and bad debt expense. The methodology for designing tests of controls and substantive tests of transactions is, in concept, the same for each of the five classes of transactions and includes the following steps:

- Understand internal control

- Assess planned control risk

- Determine the extent of testing controls

- Design tests of controls and substantive tests of transactions to meet transaction related audit objectives

In designing tests of controls for each class of transactions, auditors focus on testing internal controls that they intend to rely upon to reduce control risk. First, the auditor identifies internal controls, if any exist, for each transaction-related audit objective. After assessing control risk for each objective, the auditor then determines the extent of tests of controls that must be performed.

If the auditor is reporting on the effectiveness of internal control over financial reporting, extensive tests of controls must be performed to provide the basis for the auditor's report. For audits of non-accelerated filers and nonpublic companies, the decision to perform tests of controls is based on the effectiveness of controls and the extent to which the auditor intends to rely on them to reduce control risk.

The auditor also designs substantive tests of transactions for each class of transactions to determine whether the monetary amounts of transactions are correctly recorded. Like tests of controls, substantive tests of transactions are designed for each transaction-related audit

objective. After the design of tests of controls and substantive tests of transactions for each audit objective and each class of transactions is completed, the auditor organizes the audit procedures into a performance format audit program. The purpose of this audit program is to help the auditor complete the audit tests efficiently.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question.

1. An auditor is considering the internal control system for purchasing and disbursement procedures. The auditor will be least influenced by
 - A. The availability of a company manual describing purchasing and disbursement procedures.
 - B. The strength or weakness of internal control in other areas, e.g., sales and accounts receivable.
 - C. The scope and results of audit work by the company's internal auditor.
 - D. The existence within the purchasing and disbursement area of internal control strengths that offset weaknesses.
 - E. None of the above
2. To determine that sales transactions have been recorded in the proper accounting period, the auditor performs a cut-off review. Which of the following best describes the overall approach used when performing a cut-off review?
 - A. Ascertain that management has included in the representation letter a statement that transactions have been accounted for in the proper accounting period.
 - B. Confirm year-end transactions with regular customers.
 - C. Analyze transactions occurring within a few days before and after year-end.
 - D. Examine cash receipts in the subsequent period.
 - E. None of the above
3. Which of the following can be used as substantive test for receivables and sales transactions?
 - A. Confirm receivable with debtors.

- B. Perform analytical procedures.
 - C. Review the year-end cutoff of sales transactions.
 - D. All of the above.
4. Which of the following is (are) primary audit objective for receivables/sales?
- A. Clerical accuracy
 - B. Existence
 - C. Valuation
 - D. Statement Presentation
 - E. All of the above
5. Which assertions relating to receivables/sales are addressed when auditors select a sample of sales invoices and compare details to shipping documents?
- A. Existence
 - B. Ownership
 - C. Valuation
 - D. All

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Explain the importance of proper credit approval for sales. What effect do adequate controls in the credit function have on the auditor's evidence accumulation?
2. Distinguish between the sales journal and the accounts receivable master file. What type of information is recorded in each and how do these accounting records relate?
3. List the most important duties that should be segregated in the sales and collection cycle. Explain why it is desirable that each duty be segregated.
4. What audit procedures are most likely to be used to verify accounts receivable written off as uncollectible? State the purpose of each of these procedures.
5. State the relationship between the confirmation of accounts receivable and the results of the tests of controls and substantive tests of transactions.

CHAPTER FOUR

AUDIT OF INVENTORY AND COSTS OF GOODS SOLD

4. Learning objectives

At the end of this chapter, learners should be able to:

Develop an understanding of the purchasing process.

Identify the types of transactions in the purchasing process and the financial statement accounts affected.

Understand the functions in the purchasing process.

Identify and describe the types of documents and records used in the purchase process. Know the appropriate segregation of duties for the purchase process.

Know the appropriate segregation of duties for the inventory management process.

Identify key internal controls and develop relevant tests of controls for inventory transactions.

Identify substantive analytical procedures used to audit inventory and related accounts.

4.1. Introduction

A purchase transaction usually begins with a purchase requisition being generated by a department or support function. The purchasing department prepares a purchase order for the purchase of goods or services from a vendor. When the goods are received or the services have been rendered, the entity records a liability to the vendor. Finally, the entity pays the vendor. On the other hand, inventories are major items on the balance sheet, i.e. in total assets, especially in the current asset section. Inventories play also a very significant and important role in preparation of income statement and determination of net income or loss.

The relationship of inventories and purchase makes it logical for the two topics to be considered together. The Internal control that assures the fair valuation of inventories is found in the purchase (or acquisition) cycle. These procedures include procedures for the selection of vendors, ordering merchandise or materials, inspecting goods, receive, recording the liabilities to the vendor, and authorizing and making cash disbursements.

This chapter explains the essential control procedures and tests of controls used by the auditors for purchase and inventory. Thus student should be able to understand these procedures and Tests with relation to necessary documents and records used for control purposes. Besides, in this chapter we are going to discuss the typical internal control procedures and the auditors' objectives in the examination of inventories and purchases.

4.2. Types of Transactions and Financial Statement Accounts Affected

Three types of transactions are processed through the purchasing process:

- Purchase of goods and services for cash or credit.

- Payment of the liabilities arising from such purchases.

- Return of goods to suppliers for cash or credit.

The first type is a purchase transaction that includes acquiring goods and services. The second type is a cash disbursement transaction that involves paying the liabilities that result from purchasing goods and services. The final type is a purchase return transaction, in which goods previously purchased are returned to a supplier for cash or credit.

4.3. Types of Documents and Records

Here we are going to see the important documents and records that are normally involved in the purchasing process. Each of these items is briefly discussed here. The use of an IT system may affect the form of the documents and the auditor's approach to testing the purchasing process.

This documents and records include the following:

- Purchase Requisition** - This document requests goods or services for an authorized individual or department within the entity. Examples of such requests include an order for supplies from an office supervisor and an order for newspaper advertising space from a marketing manager.

- Purchase Order** - This document includes the description, quality, and quantity of, and other information on, the goods or services being purchased. The purchase order also indicates who approved the acquisition and represents the authorization to purchase the

goods or services. The purchase order may be mailed, faxed, or placed by telephone with the supplier or vendor.

Receiving Report - This document records the receipt of goods. Normally, the receiving report is a copy of the purchase order with the quantities omitted. This procedure encourages receiving department personnel to make an adequate, independent count of the goods received. Receiving department personnel record the date, description, quantity, and other information on this document. In some instances, the quality of the goods is determined by receiving department personnel. In other cases, an inspection department determines whether the goods meet the required specifications. The receiving report is important because receiving goods is generally the event that leads to recognition of the liability by the entity.

Vendor Invoice - This document is the bill from the vendor. The vendor invoice includes the description and quantity of the goods shipped or services provided, the price including freight, the terms of trade including cash discounts, and the date billed.

Voucher - This document is frequently used by entities to control payment for acquired goods and services. This document serves as the basis for recording a vendor's invoice in the voucher register or purchases journal. In many purchasing systems the voucher is attached to the purchase requisition, purchase order, receiving report, and vendor invoice to create a *voucher packet*. The voucher packet thus contains all the relevant documentation supporting a purchase transaction.

Voucher Register/Purchases Journal - A voucher register is used to record the vouchers for goods and services. The voucher register contains numerous columns for recording the account classifications for the goods or services, including a column for recording credits to accounts payable, and columns for recording debits to asset accounts such as inventory and expense accounts such as repairs and maintenance. The voucher register also contains columns for miscellaneous debits and credits. Some entities use a purchases journal instead of a voucher register. With a purchases journal, either vouchers or vendors' invoices may be used to record the liability. The major difference between a voucher register and a purchases journal is in the way individual vouchers or vendor invoices are summarized.

Accounts Payable Subsidiary Ledger - When a purchases journal is utilized, this subsidiary ledger records the transactions with, and the balance owed to, a vendor. When a voucher register system is used, the subsidiary ledger is a listing of the unpaid vouchers. The total in the subsidiary ledger should equal the balance in the general ledger accounts payable account.

Vendor Statement - This statement is sent monthly by the vendor to indicate the beginning balance, current-period purchases and payments, and the ending balance. The vendor's statement represents the purchase activity recorded on the vendor's records. It may differ from the client's records because of errors or, more often, timing differences due to delays in shipping goods or recording cash receipts. The client verifies the accuracy of its records by comparing vendor statements with the accounts payable records.

Check or Electronic Funds Transfer (EFT) Listing - These disbursements, signed by an authorized individual, pays for goods or services. Additionally, goods and services may be paid for through electronic transfer of funds.

Cash Disbursements Journal/Check Register - This journal records disbursements made by check. It is sometimes referred to as a *check register*. The cash disbursements journal contains columns for recording credits to cash and debits to accounts payable and cash discounts. Columns may also record miscellaneous debits and credits. Payments recorded in the cash disbursements journal are also recorded in the voucher register or in the accounts payable subsidiary ledger, depending on which system is used by the entity.

QUICK CHECK

1. List the three types of transactions that are processed through the purchasing process.
2. Discuss the important documents and records that are normally involved in the purchasing process.

4.4. The Major Functions in purchasing process

The principal business objectives of the purchasing process are acquiring goods and services at the lowest cost consistent with quality and service requirements and effectively using cash resources to pay for those goods and services. Here we are going to see the functions that are normally part of the purchasing process.

Requisitioning - The initial function in the purchasing process is a request for goods or services by an authorized individual from any department or functional area within the entity. The important issue is that the request meets the authorization procedures implemented by the entity. One frequent organizational control is the establishment of authorization dollar limits for different levels of employees and executives.

Purchasing - The purchasing function executes properly authorized purchase orders. This function is normally performed by a purchasing department, which is headed by a purchasing manager (or agent) and has one or more buyers responsible for specific goods or services. The purchasing function ensures that goods and services are acquired in appropriate quantities and at the lowest price consistent with quality standards and delivery schedules. Using multiple vendors and requiring competitive bidding are two ways the purchasing function can achieve its objectives.

Receiving - The receiving function is responsible for receiving, counting, and inspecting goods received from vendors. The personnel in the receiving department complete a receiving report that is forwarded to the accounts payable function.

Invoice Processing - The accounts payable department processes invoices to ensure that all goods and services received are recorded as assets or expenses and that the corresponding liability is recognized. This function involves matching purchase orders to receiving reports and vendor invoices as to terms, quantities, prices, and extensions. The invoice-processing function also compares the account distributions with established account classifications. The invoice-processing function is also responsible for purchased goods returned to vendors. Appropriate records and control activities must document the return of the goods and initiate any charges back to the vendor.

Disbursements - The disbursement function is responsible for preparing and signing checks for paying vendors and authorizing electronic funds transfers. Adequate

supporting documentation must verify that the disbursement is for a legitimate business purpose, that the transaction was properly authorized, and that the account distribution is appropriate. To reduce the possibility that the invoice will be paid twice, all documentation (such as purchase order, receiving report, and vendor invoice) should be marked “**CANCELED**” or “**PAID**” by the cashier’s department. Finally, the checks should be mailed to the vendor by the cashier’s department or treasurer.

Accounts Payable - The accounts payable department is also responsible for ensuring that all vendor invoices, cash disbursements, and adjustments are recorded in the accounts payable records. In IT systems, these entries may be made directly as part of the normal processing of purchase, cash disbursement, or returns and allowances transactions. Proper use of control totals and daily activity reports provides controls for proper recording.

General Ledger The main objective of the general ledger function for the purchasing process is to ensure that all purchases, cash disbursements, and payables are properly accumulated, classified, and summarized in the accounts. In an IT system the use of control or summary totals ensures that this function is performed correctly. The accounting department is normally responsible for this function.

4.5. The Key Segregation of Duties

As discussed in previous chapters, proper segregation of duties is one of the most important control activities in any accounting system. Duties should be assigned so that no one individual can control all phases of processing a transaction in a way that permits errors or fraud to go undetected. Because of the potential for theft and fraud in the purchasing process, individuals responsible for requisitioning, purchasing, and receiving should be segregated from the invoice processing, accounts payable, and general ledger functions. If IT is used in the purchasing application, there should be proper segregation of duties in the IT department.

Table below shows the key segregation of duties for the purchasing process and examples of possible errors or fraud that can result from conflicts in duties.

Table 4.1.Key Segregation of Duties in the Purchasing Process and Possible Errors or Fraud

Segregation of Duties Possible	Errors or Fraud Resulting from Conflicts of Duties
The purchasing function should be segregated from the requisitioning and receiving functions	If one individual is responsible for the requisition, purchasing, and receiving functions, fictitious or unauthorized purchases can be made. This can result in the theft of goods and possibly payment for unauthorized purchases.
The invoice-processing function should be segregated from the accounts payable function.	If one individual is responsible for the invoice-processing and the accounts payable functions, purchase transactions can be processed at the wrong price or terms, or a cash disbursement can be processed for goods or services not received. This can result in overpayment for goods and services or the theft of cash.
The disbursement function should be segregated from the accounts payable function.	If one individual is responsible for the disbursement function and also has access to the accounts payable records, unauthorized checks supported by fictitious documents can be issued, and unauthorized transactions can be recorded. This can result in theft of the entity's cash.
The accounts payable function should be segregated from the general ledger function.	If one individual is responsible for the accounts payable records and also for the general ledger, that individual can conceal any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account.

QUICK CHECK

1. Discuss the key segregation of duties in purchase procedures.

4.6. Control Activities and Tests of Controls - Purchase Transactions

There are seven control procedures applied for control of purchase transactions which includes the following points:

Validity - the Auditors concern in testing of the validity of purchase transaction is that factious or non-existent purchase may have been recorded in the client's records. If fraudulent transactions are recorded, assets or expenses will be overstated. A liability will also be recorded and a resulting payment made, usually to the individuals who initiated the factious purchase transactions proper segregation is the control test for preventing factious purchases. The critical segregation of duties is the separation of the reacquisition, and purchasing functions from the accounts payable and disbursement functions.

Completeness of purchase transaction- If the client fails to record a purchase that has been made assets or expenses will be understated and the corresponding accounts payable will also understate. Control Test that provides assurance that the completeness objective is being met includes accounting or checking the numerical sequence of purchase orders, receiving Reports, and Vouchers; matching receiving vouchers with vender invoices, etc.

Timeliness of recording of purchase transaction - the client should have controls to ensure that purchase transactions are recorded on timely basis (in a proper time). For example, the client's procedure should require that all receiving reports should be forwarded to the accounts payable department or section on daily basis.

Authorization of purchase transaction - possible misstatements due to improper authorization includes the purchase of unauthorized goods and the purchase of goods or services at unauthorized price or terms. The major control procedure to prevent these misstatements is the use of authorization schedule or table which shows the amount that different levels of employees (personnel) are authorized to purchase.

Cutoff of Purchase Transactions - The client should have controls to ensure that purchase transactions are recorded promptly and in the proper period. For example, the client's procedures should require that all receiving reports be forwarded to the accounts payable department daily. There should also be a requirement in the accounts payable department that receiving reports be matched on a timely basis with the original purchase order and the related vendor invoice. The auditor can test these control activities by

comparing the date on the receiving report with the date on the voucher. There should seldom be a long period between the two dates. The auditor also wants to ensure that the vouchers are recorded in the accounting records in the correct period. This can be tested by comparing the dates on vouchers with the dates the vouchers were recorded in the voucher register.

Valuation of purchase transactions - The possible misstatements for valuation of Internal control objective is that purchase transactions may be recorded at in correct amounts due to improper pricing or erroneous calculation.

Classification of purchases - Proper classification of purchase transactions is an important internal control objective for the purchasing cycle. If purchase transactions are not properly classified, asset and expense accounts will be misstated. A control test for this objective is proper documentation and records for example having chart of accounts.

**QUICK CHECK**

1. What are the major control activities and tests of controls in purchase transactions?

4.7. Inventory Transactions

The inventory cycle is affected by the control procedures previously discussed for cash receipts review purchasing, and payroll cycles. The acquisition of and payment for raw materials and overhead costs is controlled via the purchasing cycle. The cost of both direct and indirect labor assigned to inventory is controlled through payroll cycle. Finally, finished goods are sold and accounted for as part of revenue cycle. Thus, the cycle for Inventory in manufacturing company begins when goods are purchased and stored as raw materials, proceeds to the processing of the goods through manufacturing departments, and ends when the finished goods are shipped to customers.

4.8. Control Activities and Tests of Controls - Inventory Transactions

Here we are going to discuss of the control activities, and selected tests of controls for inventory transactions. The discussion includes control activities that are present in a manufacturing setting. A number of control activities in the revenue and purchasing processes provide assurance for selected assertions for inventory.

The discussion is limited to the more important assertions and it includes the following control activities and test of control points:

Occurrence of Inventory Transactions: The auditor's main concern is that all recorded inventory exists. The major control activity for preventing fictitious inventory transactions from being recorded is proper segregation of duties, in which the inventory management and inventory stores functions are separated from the departments responsible for inventory and cost-accounting records. This control prevents operating personnel from having access to both inventory and the perpetual inventory records. Additionally, prenumbered documents to handle the receipt, transfer, and withdrawal of inventory may prevent the recording of fictitious inventory in the accounting records.

Completeness of Inventory Transactions: The control activities for the completeness assertion relate to recording inventory that has been received. Typically, the control activities for this assertion are contained within the purchasing process. For example, in some instances, additional control activities may be used in the raw materials stores department to ensure that the goods are recorded in the perpetual inventory records. This might include comparing a summary of the receiving reports to the inventory status report.

Authorization of Inventory Transactions: The auditor's concern with authorization in the inventory system is with unauthorized purchase or production activity that may lead to excess levels of certain types of finished goods. If such goods can quickly become obsolete, ending inventory may be overstated. The use of some type of inventory-planning system, such as a material requirements planning system or a just-in-time inventory system, may also limit unauthorized production.

Accuracy of Inventory Transactions: Accuracy is an important assertion because inventory transactions that are not properly recorded result in misstatements that directly affect the amounts reported in the financial statements for cost of goods sold and inventory. The accurate processing of inventory purchase transactions involves applying

the correct price to the actual quantity received. Similarly, when inventory is shipped, accurate processing requires that the actual number of items shipped be removed from inventory and that the proper cost be recorded to cost of goods sold. The use of a perpetual inventory system in conjunction with a periodic or annual physical inventory count should result in the proper quantities of inventory being shown in the client's perpetual inventory records.

Cutoff of Inventory Transactions: Inventory transactions recorded in the improper period could affect a number of accounts, as illustrated by this simple inventory computation:

$$\text{Beginning inventory} + \text{Purchases} - \text{Cost of goods sold} = \text{Ending inventory}$$

The cutoff risks, control activities, and tests of controls associated with inventory transactions were already addressed in revenue and purchase cycle, since the sale of inventory involves the revenue process and purchase of inventory involves the purchasing process. For sold (purchased) inventory, a common test of the client's controls to ensure transactions are recorded in a timely manner is to compare the date on the shipping document (receiving report) with the date in the sales journal (payment voucher). There should not be a long period between these two dates. As discussed later, auditors also often focus tests of details on transactions near year-end. It is important to understand that failure to record inventory in the proper period can result in misstatements on both the balance sheet and income statement.

Classification of Inventory Transactions: In a manufacturing company, the client must have control activities to ensure that inventory is properly classified as raw materials, work in process, or finished goods. This can usually be accomplished by determining which departments in the manufacturing process are included in raw materials, work in process, and finished goods inventory. Thus, by knowing which manufacturing department holds the inventory, the client is able to classify it by type.

QUICK CHECK

1. What are the major control activities and tests of controls in inventory transactions?

4.9.The auditors' objectives in the examination of inventories and purchases

The auditors' have the following objectives in the examination of inventories and purchases.

- To consider internal control over inventories and purchases.

 - To determine the existence of inventories, and the client's ownership of these assets.

 - To establish the completeness of inventories and purchase transaction.

 - To establish clerical accuracy of records and supporting schedules for inventories and purchases.

- To determine that the valuation inventories is based on appropriate methods.

 - To determine the statement presentation of inventories is adequate, including disclosure of classification of inventories, accounting records and any inventories pledged as collateral for loans.

4.10. Internal control over inventories and purchases control objectives

Although inventory records may vary considerably from client to client, the control objectives of a sound system of internal control over inventories are the same in all cases, namely:

- Authorization and purchase procedures.

- Control over goods inwards.

- Inventory records substantiated by physical counts.

- Control over dispatches and goods outwards.

- Inventory levels should be controlled so that materials are available when required but that inventory is not unnecessarily large. Control procedures over inventories.

Internal control procedures for inventories affect nearly all the functions involved in producing and disposing of the company's products, purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories. The basic internal control procedures are the following:

QUICK CHECK

1. What are the auditor objectives and internal control objective in the examination of inventories and purchases?

4.11. Limitations (weakness) of internal control over Inventory

Internal control weaknesses to observe in inventory audit are:

Purchases: ordering unauthorized goods: goods that are not needed by the organization may be ordered for personal whim at the cost of the organization. goods ordered can also be diverted before they can enter into the organization. in this connection, in depth examination of purchase requisition, purchase order and store receiving reports are important.

Over invoicing: purchases may be made at prices especially agreed between purchaser and supplier to include commission. The venders invoice is thus over invoiced to include kick back to the purchaser. Hence, it is necessary to check the competitiveness of suppliers in terms of price, quality and delivery time.

Inventory valuation: there are different inventory valuation methods and each organization may have the prerogative to use inventory methods it deems appropriate. However, the auditor must carefully note the effect of different methods of valuation on net income, taxes and balance sheet in order to avoid presentation of misleading information or misstatement of overall financial position. The importance of the accuracy of clerical operation here is also obvious. There are many opportunities for intentional or unintentional errors for misstatement of facts or fraud.

Physical inventory: establishment of existence of physical inventory first involves a matter of physical count only, which by itself is problematic. especially I counting packaged goods or held in big container whose unfolding and emptying may cause damage to goods, i.e sacks of coffee, bottles of whisky, barrels of oil or sensitive scientific instruments such as lenses. As a result, it is possible to count or observe physical count of empty containers with sham contents. Problem also arises with inventory found in distant geographical location. Secondly, establishment of physical

inventory involves determining inventory ownership title by ensuring title transfer, which can be corroborated by examining terms of sale or purchase. Moreover, it is important to be aware of alternative methods of satisfying oneself of physical existence of inventory, and examining goods-in-transit or on consignment and or on installment sales.

4.12. Audit procedures of inventories and purchases

The following audit procedures for the verification of inventories and purchases may be used by auditors:

- A ***Obtain an understanding of internal control for inventories and purchases:*** In obtaining an understanding of internal control over inventory, the auditor should become thoroughly conversant with the procedures for purchasing, receiving, storing, and issuing goods as well as acquiring an understanding of the cost accounting system and the perpetual records.
- B ***Assess control risk and design additional tests of control for inventories and purchases:*** After obtaining an understanding of the client's internal control over inventories and purchases, the auditors perform their initial assessment of control risk for the various financial statement assertions.
- C ***Perform additional tests of controls:*** Tests directed toward the effectiveness of controls help to evaluate the client's internal control and to determine the extent to which the auditors are justified in reducing their assessed level of control risk for the assessments about the inventory and purchase accounts. The following are examples of typical additional test.
 - Examine significant aspects of a sample of purchase transactions. Test the cost accounting system.
 - Reassess control risk and design substantive tests.
- D ***Perform the following Substantive tests:***
 - Obtain listings of inventory and reconcile to ledgers.
 - Evaluate the client's planning of physical inventory.
 - Observe the taking of physical inventory and make test counts.
 - Review the year – end cutoff of purchases and sales transactions.

Obtain a copy of the completed physical inventory, test its clerical accuracy, and trace test counts.

Evaluate the bales and methods of inventory pricing. Review inventory quality and condition.

Perform analytical procedures.

Determine whether any inventories have been pledged and review purchase and sales commitments.

Evaluate financial statement presentation of inventories, including the adequacy of disclosure

QUICK CHECK

1. Discuss the audit procedures for the verification of inventories and purchases used by auditors:

Summary

In this chapter, we discussed the audit of the inventory and purchase cycle. Because of the difficulties associated with establishing the existence and valuation of inventories, the cycle is often the most time-consuming and complex part of the audit. This cycle is also unique because many of the tests of the inputs to the cycle are tested as part of the audit of other cycles.

A purchase transaction usually begins with a purchase requisition being generated by a department or support function. The purchasing department prepares a purchase order for the purchase of goods or services from a vendor. When the goods are received or the services have been rendered, the entity records a liability to the vendor. Finally, the entity pays the vendor. On the other hand, inventories are major items on the balance sheet, i.e. in total assets, especially in the current asset section. Inventories play also a very significant and important role in preparation of income statement and determination of net income or loss.

The relationship of inventories and purchase makes it logical for the two topics to be considered together. The Internal control that assures the fair valuation of inventories is found in the purchase (or acquisition) cycle. These procedures include procedures for the selection of vendors, ordering merchandise or materials, inspecting goods, receive, recording the liabilities to the vendor, and authorizing and making cash disbursements.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question.

1. When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that
 - A. All goods purchased before year-end are received before the physical inventory count.
 - B. No goods held on consignment for customers are included in the inventory balance.
 - C. No goods observed during the physical count are pledged or sold.
 - D. All goods owned at year-end are included in the inventory balance.
 - E. None of the above
2. In an audit of inventories, an auditor would least likely verify that
 - A. All inventory owned by the clients is on hand at the time of the count.
 - B. The client has used proper inventory pricing.
 - C. The financial statement presentation of inventories is appropriate.
 - D. Damaged goods and obsolete items have been properly accounted for.
 - E. None of the above
3. The financial statement assertion of valuation is not related to inventories.
 - A. True
 - B. False
4. Efficient and effective inventory taking requires careful planning in advance.
 - A. True
 - B. False
5. Auditors should not observe the quality or condition of inventories
 - A. True
 - B. False

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. What major types of transactions occur in the purchasing process? What financial statement accounts are affected by each type of transaction?
2. Briefly describe each of the following documents or records: purchase requisition, purchase order, receiving report, vendor invoice, and voucher. Why would an entity combine all documents related to a purchase transaction into a “voucher packet”?
3. List the key segregation of duties in the purchasing process. What errors or fraud can occur if such duties are not segregated?
4. What control activities typically ensure that the occurrence, authorization, and completeness assertions are met for a purchase transaction? What tests of controls are performed for each of these assertions?
5. Briefly describe each of the following documents or records: production schedule, materials requisition, inventory master file, production data information, and cost accumulation and variance reports.
6. List three substantive analytical procedures that can test the fairness of inventory and related accounts.

CHAPTER FIVE

AUDIT OF FIXED ASSETS

5. LEARNING OBJECTIVES

At the end of this chapter, the learners should be able to:

Understand the objectives fixed assets audit

Know audit procedures of fixed assets audit

Describe the internal control checklist for fixed asset
audit Understand the verification of fixed asset audit

Design typical test of control used by auditors to evaluate the effectiveness of control
over fixed asset audit

5.1. Introduction

Dear Learners! It is obvious that every private and governmental sectors have a fixed assets held in order to accomplish the day to day activities and those assets must be audited. Accordingly, fixed assets are those assets acquired by a business for the purpose of use in the business with the objective of earnings revenue, and which are not intended for resale at a profit and conversion into cash in the ordinary course of business. They may broadly be classified into tangible assets and intangible assets. Tangible assets are those which have definite shapes and which can be seen, e.g., plant and machinery including motor vehicles, land and buildings, furniture and fittings, investment properties, etc. Intangible fixed assets are those which are not perceptible by touch, but nevertheless employed in the business for earning revenue, e.g. patents, copy rights, trade marks, goodwill deferred expenditure such as development costs and franchises etc.

There are four types' transactions in fixed assets. These are acquisition of capital assets for cash, or other non-monetary considerations (exchange by other fixed assets); disposition of capital (fixed assets) through sale, exchange, retirement, or abandonment; depreciation of capital assets over their useful economic life and Leasing of capital assets.

The primary accounting record for equipment and other property, plant, and equipment accounts is generally a **fixed asset master file**. The master file includes a detailed record for each piece of equipment and other types of property owned. Each record in the file includes a description of the asset, date of acquisition, original cost, current year depreciation, and accumulated depreciation for the property. The totals for all records in the master file equal the general ledger balances for the related accounts: ***equipment, depreciation expense, and accumulated depreciation***. The master file also contains information about property acquired and disposed of during the year. Auditors verify equipment differently from current asset accounts for three reasons:

1. There are usually fewer current period acquisitions of equipment, especially large equipment used in manufacturing.
2. The amount of any given acquisition is often material.
3. The equipment is likely to be kept and maintained in the accounting records for several years.

Because of these differences, the auditing of equipment emphasizes the verification of current period acquisitions rather than the balance in the account carried forward from the preceding year.

Therefore, this chapter deals with the audit of fixed asset for instance, its objectives, internal control, basic procedures, and tests undertaken by the auditor.

5.2. Audit Objectives of Fixed Assets

The audit objectives in the verification of fixed assets in short are the following:

1. The verification of existence;
2. The verification of ownership;
3. The examination and full disclosure of the valuation methods used (and also of the depreciation policies, where applicable);
4. The verification of the propriety of the fixed asset transaction for the year under audit; and,
5. The review and evaluation of the internal control,

6. An audit of fixed assets significantly varies from an audit of current assets (cash, receivable, stocks, etc.). Current assets are of short life usually falling due within an accounting period of one year whereas fixed assets are of a long life.

So, the auditors' objectives in fixed asset audit are to determine that:

The recorded property , plant, and equipment is valid (existence and right)

All property , plant, and equipment is recorded (completeness)

Property , plant, and equipment records an supporting schedules are mathematically correct and agree with general ledger account (clerical accuracy)

The valuation of fixed assets is proper (valuation)

The presentation and disclosure of fixed assets , including disclosure of depreciation method, is adequate (disclosure)

All these items we can summarized here under in the table 4.1.

Table 5.1: General audit objectives of fixed assets

S.No.	Audit objectives	Purpose
1	Internal control	To ensure that all the necessary controls over plant (fixed) assets were applied by the management of the client.
2	Completeness	To ensure that all fixed assets owned by the entity at the end of the accounting period have been recorded.
3	Existence	To ensure that the recorded fixed assets were in existence at the end of the accounting period and remain in use by the entity.
4	Ownership	To ensure that the recorded fixed assets were properly owned by the entity at the end of the accounting period and that all lines and other loaded on them have been properly identified.
5	Valuation	To ensure that the recorded fixed assets were properly valued at the end of the accounting period in

		accordance with GAAP.
6	Disclosure	To ensure that the disclosure of fixed assets is to accordance with GAAP.

QUICK CHECK

1. Describe the objectives of audit of fixed assets?

5.3. Nature of Internal control over fixed assets audit

This sub section took about the nature of internal control over fixed assets audit. Hence, it comprise of validity and authorization, completeness and segregation of duties. Let us discuss one by one.

1. Validity and Authorization

The control procedures for the validity and Authorization objectives are normally part of the purchasing cycle. Purchase reacquisition are initiated in relevant departments and authorized at the appropriate level within the entity. However large capital asset transactions may be subject to control procedures outside the purchasing cycle for example, highly specialized equipment may require skilled engineers approval for the technical specifications for the equipment, for such transactions, the auditor may need to examine more than the vendors invoices to test validity; review of additional documentations, such as capital – budgeting documents and engineering specifications may be needed.

2. Completeness

The control procedures used in the purchasing cycle for ensuring completeness provide some assurance that all capital asset transactions are recorded in the property, plant, and equipment subsidiary ledger and general ledger. One procedure that helps to ensure that this objective is met is reconciliation of the property, plant and equipment subsidiary ledger to the general ledger one procedure that helps to ensure that this objective is met is reconciliation of the property, plant and equipment subsidiary ledger to the general ledger control accounts on monthly basis.

Another control procedure that an entity may use to ensure that all capital assets are recorded is periodic comparison of the detailed records in the subsidiary ledger with the existing capital assets. The client may take a complete physical examination of property, plant, and equipment on periodic or rotating basis and compare the physical asset to the subsidiary ledger.

3. Segregation of duties

The existence of adequate segregation of duties for property, plant and equipment within an entity depends on the volume and significance of the transaction processed. For example, if an entity purchases large quantities of machinery and equipment, or if it has large capital projects under construction, there is a likely to be a formal internal control system. On the other hand, if an entity has few capital purchases, the entity will generally not have formal control system.

The following notes show the key segregation of duties for property, plant, and equipment transactions.

1. If one individual is responsible for initiating a capital asset transaction and also has final approval, it is possible for fictitious or unauthorized purchases of assets to occur. This can result in purchases of unnecessary assets, assets that do not meet the company's quality control standards, or illegal payments to suppliers or contractors. Thus, there must be final approval functions.
2. If one individual is responsible for the records and also for the general ledger functions, It is possible for that individual to conceal (fraud) any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account. Thus, the recording function should be segregated from the general ledger function.
3. If one Individual is responsible for the records and also has custodian responsibility for the related assets, it is possible for tools and equipment to be stolen and for the theft to be concealed by adjustment of the accounting records. Thus, the recording functions should be segregated from the custodian function.
4. If the individual, who is responsible for the periodic physical inventory fixed assets, is also responsible for the custodian and record keeping functions, it is possible for theft of the entity's capital assets to be concealed. Thus, individual responsible for the inventory should be independent of the custodian and record keeping functions.

5.4. Internal control principles for fixed asset audit

The most important controls applicable in fixed assets are as follows:

A subsidiary ledger consisting of separate records for each unit of property .an adequate fixed asset ledger facilitates your work in analyzing additions and retirement; in verifying depreciation provision and maintenance expenses; and in compering authorization with actual expenditure.

A system of authorization requiring advance executives approval of all assets whether by purchase, lease or construction.

A reporting procedures assuring prompt disclosure and analysis of variances between authorized expenditure and actual costs.

A policy requiring all purchase of fixed assets to be handled through the purchasing department and subjected to standard routine for receiving , inspection, and payment.

Periodic physical inventories designed to verify the existence, location, and conditions of all property listed in the account and disclose the existence of any unrecorded units.

The reconciliation of detailed records with control accounts Physical security over fixed asset and of appropriate, the title to fixed assets recorded in the accounts.

5.4.1. Internal control questionnaires for fixed assets

The following table summarized some of the checklist for internal control related to fixed assets.

Table 4.2: Sample internal control questionnaires

S.no	Items
1	Are fixed assets register or similar records maintain detailed the cost and accumulated depreciation of each individual asset and identifying each asset by number which also appears on the asset itself?
2	Are these records maintained by persons other than those responsible for the custody to the physical properties?
3	Are the detailed records agreed at least annually for each class of asset with the cost and accumulated depreciation according to the general ledger account?
4	Is a nominal book value in respect of fully depreciated asset retained in the records until the assets are disposed of?
5	Is the original cost and accumulated depreciation eliminated from the accounting records

and fixed assets records whenever an asset is sold or scrapped?

- 6 Are adequate records maintained of capital works in progress to identify expenditure incurred on each separate project and provide proper control over cost?
- 7 Are adequate records maintained to control small toll, cutlery, line and other miscellaneous items?
- 8 Are fixed assets adequately physical safeguarded?
- 9 Are fixed assets adequately covered by insurance?
- 10 Are physical inventories of fixed assets taken periodically by or under the supervision of employees not responsible for physical custody or recorded keeping of such properties?
- 11 Is adequate follow-up action taken by management in respect of assets reported as missing or damaged?
- 12 Are document of title kept in safe custody and controlled by register?

5.5. Audit procedures for fixed assets

The audit procedures for fixed assets are in general similar to the procedures for other items. The audit of fixed assets involves the examination of fixed assets records and evidences such as contracts, invoices, and receipt documents. Regarding proposed acquisitions of fixed assets some of the questions that may need to be answered are the following:

Will the acquisition of new fixed assets improve the efficiency of the Public Body in achieving its objectives?

Will expenses be reduced by the acquisition of the fixed assets?

What will the acquisition of the new fixed assets cost the Public Body and what will the savings be in terms of finances?

How many years will the new fixed asset serve at a lower running and maintenance cost and when should it be replaced or disposed of?

The following procedures were taken in to account while the auditors engaged in the audit of fixed assets.

4. To ascertain that validity of the recorded of fixed assets:

 Examine the fixed asset register, and trace the balance to the ledger account and the balance sheet.

- ✚ Trace the purchase invoice during the year to the fixed asset register, the ledger account and the balance sheet.
 - ✚ Examine the purchase invoice to verify that all the fixed assets acquisitions recorded in the books are for transaction that have occurred,
 - ✚ Review minutes of the executive committee for approval of acquisitions.
 - ✚ Physical observation of assets to ascertain existence of fixed assets.
5. To verify the completeness of the fixed asset records, apply the following audit procedures.
- ✚ Examine the fixed asset register, and trace the balance to the ledger account and balance sheet.
 - ✚ Trace the purchase invoices during the year to fixed asset register, the ledger account and the balance sheet.
 - ✚ Examine plant asset acquisition and disposal to make sure that these transactions are in the right period.
6. To verify the clerical accuracy of reconcile the figure of cost, accumulated depreciation and book value with the corresponding figure in the previous year end.
- ✚ Verify calculation of depreciation
 - ✚ Examine the valuation of assets acquisition
 - ✚ Verify arithmetic accuracy of additions
 - ✚ Examine sales invoices and accounting records for disposal and check that depreciation is calculated to date of disposal.
7. For proper disclosure and presentation in the financial statement, you have to examine the chart of account and the balance sheet for the proper presentation of fixed asset, separate from current asset and notes to the financial statements regarding depreciation.

QUICK CHECK

1. Describe the major procedures undertaken by the auditors in audit of fixed assets?
2. Write the most important controls applicable in fixed assets

5.6. Verification of Fixed assets audit

In the audit of equipment as fixed asset and related accounts, it is helpful to separate the tests into the following categories:

- Perform analytical procedures

- Verify current year acquisitions

- Verify current year disposals

- Verify the ending balance in the asset account

- Verify depreciation expense

- Verify the ending balance in accumulated depreciation

Next, let's examine the use of these categories of tests in the audit of equipment, depreciation expense, accumulated depreciation, and gain or loss on disposal accounts.

5.6.1. Perform Analytical Procedures

As in all audit areas, the type of analytical procedures depends on the nature of the client's operations. The following Table 4.3 illustrates analytical procedures often performed for equipment as fixed asset.

Table 5.3: Analytical procedure for equipment audit

Analytical producers	Possible misstatements
Compare depreciation expense divided by gross equipment cost with previous years.	Misstatement in depreciation expense and accumulated depreciation
Compare accumulated depreciation divided by gross equipment cost with previous years.	Misstatement in accumulated depreciation.
Compare monthly or annual repairs and maintenance, supplies expense, small tools expense, and similar accounts with previous years.	Expensing amounts that should be capitalized.
Compare gross manufacturing cost divided by some Idle measure of production with previous years	Equipment or equipment that was disposed of but not written off.

As you can see, most of the typical analytical procedures assess the likelihood of material misstatements in depreciation expense and accumulated depreciation.

5.6.2. Verify Current Year Acquisitions

Companies must correctly record current year additions because the assets have long-term effects on the financial statements. The failure to capitalize a fixed asset, or the recording of an acquisition at the incorrect amount, affects the balance sheet until the company disposes of the asset. The income statement is affected until the asset is fully depreciated.

Because of the importance of current period acquisitions in the audit of equipment, auditors use seven of the eight balance-related audit objectives as a frame of reference for tests of details of balances: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations.

The balance-related audit objectives and common audit tests are shown in the following table 5.4. *Existence, completeness, accuracy, classification, and rights* are usually the major objectives for this part of the audit.

As in all other audit areas, the actual audit tests and sample size depend heavily on tolerable misstatement, inherent risk, and assessed control risk. Tolerable misstatement is important for verifying current year additions because these transactions vary from immaterial amounts in some years to a large number of significant acquisitions in others.

Table 5.4: **Balance-Related Audit Objectives and Tests of Details of Balances for Equipment Additions**

Balance-Related Audit Objective	Common Tests of Details of Balances Procedures	Comments
Current year acquisitions in the Acquisitions schedule agree with tolerated master file amounts, and the total agrees with the general descriptions. ledger (detail tie-in).	Foot the acquisitions schedule. Trace the individual acquisitions and the master file for amounts Trace the total to the general ledger	Footings the acquisitions schedule and tracing individual acquisitions should be limited unless controls are deficient All increases in the general ledger balance for the year should reconcile to the schedule
Current year acquisitions as listed exist (existence).	Examine vendors' invoices and receiving reports. Physically examine assets	It is uncommon to physically examine assets acquired unless controls are deficient or amounts are material.
Existing acquisitions are	Examine vendors' invoices of	This objective is one of the

recorded (completeness)	closely related (accounts such as repairs and maintenance. To uncover items that should be recorded as equipment. Review lease and rental agreements	most important for equipment
Current year acquisitions as listed are accurate (accuracy).	Examine vendors' invoices.	Extent depends on inherent risk and effectiveness of internal controls.
Current year acquisitions are recorded in the correct period (cutoff).	Review transactions near the balance sheet date for correct period	Usually done as part of accounts payable cutoff tests
The client has rights to current year acquisitions (rights).	Examine vendors' invoices.	Ordinarily the main concern is whether equipment is owned or leased. Purchase or lease contracts are examined for equipment and property deeds, abstracts, and tax bills are frequently examined fore land or major buildings.
Current year acquisitions as listed are correctly classified (classification).	Examine vendors' invoices in various should be classified as manufacturing or office equipment, part of the buildings, or repairs. Examine vendors' invoices of closely related accounts such as repairs to uncover items that should be recorded as equipment. Examine rent and lease expense for capitalizable leases.	The objective is closely related to tests for completeness. It is done in conjunction with that objective and tests for accuracy.

The starting point for the verification of current year acquisitions is normally a schedule obtained from the client of all acquisitions recorded in the general ledger property, plant, and equipment accounts during the year. The client obtains this information from the property master file. A typical schedule lists each addition separately and includes the date of the acquisition, vendor, description, notation of whether it is new or used, life of the asset for depreciation purposes, depreciation method, and cost.

In testing acquisitions, the auditor must understand accounting standards to make certain the client follows the related requirements. For example, the auditor needs to be alert for the possibility of the client's failure to include material transportation and installation costs as part of the asset's acquisition cost and the failure to properly record the trade-in of existing equipment. The auditor also needs to know the client's capitalization policies to determine whether acquisitions are treated consistently with those of the preceding year. For example, if the client's policy is to automatically expense acquisitions that are less than a certain amount, such as birr1,000, the auditor should verify that the policy is followed in the current year.

Auditors should also verify recorded transactions for correct classification among various equipment accounts. In some cases, amounts recorded as manufacturing equipment should be classified as office equipment or as a part of the building. Clients commonly include transactions that should be recorded as assets in repairs and maintenance expense, lease expense, supplies, small tools, and similar accounts.

The misstatement may result from a lack of understanding accounting standards or from clients' desires to avoid income taxes. If auditors conclude this type of material misstatement is likely, they may need to vouch larger amounts debited to the expense accounts. It is a common practice to do so as part of the audit of the property, plant, and equipment accounts.

Auditors also need to examine whether the client has a right to record equipment as an asset. Some large manufacturing equipment and other types of machinery, such as sophisticated medical equipment or computer data center equipment, may be under an operating lease. Auditors frequently examine purchase or lease contracts to determine whether capitalization of the equipment is appropriate.

5.6.3. Verify Current Year Disposals

Transactions involving the disposal of equipment are often misstated when company internal controls lack a formal method to inform management of the sale, trade-in, abandonment, or theft of recorded machinery and equipment. If the client fails to record disposals, the original cost of the equipment account will be overstated indefinitely, and net book value will be overstated until the asset is fully depreciated.

Formal methods of tracking disposals and provisions for proper authorization of the sale or other disposal of equipment help reduce the risk of misstatement. There should also be adequate internal verification of recorded disposals to make sure that assets are correctly removed from the accounting records.

The auditor's main objectives in the verification of the sale, trade-in, or abandonment of equipment are to gather sufficient appropriate evidence that all disposals are recorded and at the correct amounts. The starting point for verifying disposals is the client's schedule of recorded disposals. The schedule typically includes the date when the asset was disposed of, name of the person or firm acquiring the asset, selling price, original cost, acquisition date, and accumulated depreciation.

Detail tie-in tests of the recorded disposals schedule are necessary, including footing the schedule, tracing the totals on the schedule to the recorded disposals in the general ledger, and tracing the cost and accumulated depreciation of the disposals to the property master file.

Because the failure to record disposals of equipment no longer used in the business can significantly affect the financial statements, the search for unrecorded disposals is essential. The nature and adequacy of the controls over disposals affect the extent of the search. The following procedures are often used for verifying disposals:

- Review whether newly acquired assets replace existing assets

- Analyze gains and losses on the disposal of assets and miscellaneous income for receipts from the disposal of assets

- Review plant modifications and changes in product line, changes in major costly computer-related equipment, property taxes, or insurance coverage for indications of deletions of equipment

- Make inquiries of management and production personnel about the possibility of the disposal of assets .When an asset is sold or disposed of without having been traded in for a replacement asset, the **accuracy**of the transaction can be verified by examining the related sales invoice and property master file. The auditor should compare the cost and accumulated depreciation in the master file with the recorded entry in the general journal and re-compute the gain or loss on the disposal of the asset for comparison with the accounting records. When trade-in of an asset for a replacement occurs, the auditor should be sure that the new asset is capitalized and the replaced asset correctly eliminated

from the records, considering the book value of the asset traded in and the additional cost of the new asset.

5.6.4. Verify Ending Balance of Asset Account

Two of the auditor's objectives when auditing the ending balance in the equipment accounts include determining that:

1. All recorded equipment physically exists on the balance sheet date (***existence***).
2. All equipment owned is recorded (***completeness***). When designing audit tests to meet these objectives, auditors first consider the nature of internal controls over equipment. Ideally, auditors are able to conclude that controls are sufficiently strong to allow them to rely on balances carried forward from the prior year. Important controls include the use of a master file for individual fixed assets, adequate physical controls over assets that are easily movable (such as computers, tools, and vehicles), assignment of identification numbers to each plant asset, and periodic physical count of fixed assets and their reconciliation by accounting personnel. A formal method of informing the accounting department of all disposals of fixed assets is also an important control over the balance of assets carried forward into the current year.

Typically, the first audit step concerns the detail tie-in objective: Equipment, as listed in the master file, agrees with the general ledger. Examining a printout of the master file that totals to the general ledger balance is ordinarily sufficient. The auditor may choose to use audit software to foot an electronic version of the master file or manually test-foot a few pages.

After assessing control risk for the existence objective, the auditor decides whether it is necessary to verify the existence of individual items of equipment included in the master file. If there is a high likelihood of a material amount of missing fixed assets still included in the master file, the auditor can select a sample from the master file and examine the actual assets. Similarly, based on the auditor's assessment of control risk for the completeness objective, the auditor may physically examine a sample of major equipment items and trace them to the master file. In rare cases, the auditor may decide it is necessary for the client to take a complete physical inventory of fixed assets to make sure they all exist, and the fixed asset records are complete. If a physical inventory is taken, the auditor normally observes the count.

The auditor normally does not need to test the accuracy or classification of fixed assets recorded in prior periods because, presumably, they were verified in previous audits at the time they were acquired. But the auditor should be aware that companies may occasionally have equipment on hand that is no longer used in operations. If the amounts are material, the auditor should evaluate whether they should be written down to net realizable value (realizable value objective) or at least classified separately as “non-operating equipment.”

In addition to performing procedures to obtain evidence related to balance-related audit objectives for fixed assets, auditors also perform audit procedures related to the four presentation and disclosure objectives for fixed assets. A major consideration in verifying disclosures related to fixed assets is the possibility of legal encumbrances. Auditors may use several methods to determine whether equipment is encumbered, including:

- Read the terms of loan and credit agreements

- Mail loan confirmation requests to banks and other lending institutions

- Have discussions with the client or send letters to legal counsel

The proper presentation and disclosure of equipment in the financial statements must be evaluated carefully to make sure that accounting standards are followed.

Equipment should include the gross cost and should ordinarily be separated from other fixed assets. Leased property should also be disclosed separately, and all liens on property must be included in the footnotes. Auditors must perform sufficient tests to verify that all four presentation and disclosure objectives are met.

5.6.5. Verify Depreciation Expense

Depreciation expense is one of the few expense accounts not verified as part of tests of controls and substantive tests of transactions. The recorded amounts are determined by ***internal allocations*** rather than by exchange transactions with outside parties. When depreciation expense is material, more tests of details of depreciation expense are required than for an account that has already been verified through tests of controls and substantive tests of transactions.

The most important balance-related audit objective for depreciation expense is accuracy. Auditors focus on determining whether the client followed a consistent depreciation policy from period to period, and the client’s calculations are correct.

In determining the former, auditors must weigh four considerations:

1. The useful life of current period acquisitions
2. The method of depreciation
3. The estimated salvage value
4. The policy of depreciating assets in the year of acquisition and disposition

The client's policies can be determined by discussions with appropriate personnel and comparing their responses with information in the auditor's permanent files. In deciding on the reasonableness of the useful lives assigned to newly acquired assets, the auditor must consider the physical life of the asset, the expected life (taking into account obsolescence or the company's normal policy of upgrading equipment), and established company policies on trading in equipment.

Occasionally, changing circumstances may necessitate a company to reevaluate the useful life of an asset. When this occurs, the revaluation should involve a change in accounting estimate rather than a change in accounting principle. The effect of this on depreciation must be evaluated.

A useful method of auditing depreciation is an analytical procedures test of reasonableness made by multiplying un depreciated fixed assets by the depreciation rate for the year. In making these calculations, the auditor must make adjustments for current year additions and disposals, assets with different lengths of life, and assets with different methods of depreciation. Many CPA firms maintain an electronic spreadsheet in their permanent file that includes a breakdown of the fixed assets by method of depreciation and length of life. If the software calculations are reasonably close to the client's totals and if assessed control risk for depreciation expense is low, tests of details for depreciation can be eliminated.

When an overall reasonableness test cannot be accomplished, more detailed tests are usually needed. To do this, auditors re-compute depreciation expense for selected assets to determine whether the client is following a proper and consistent depreciation policy. To be relevant, the detailed calculations should be tied in to the total depreciation calculations by footing the depreciation expense on the property master file and reconciling the total with the general ledger. Because accounting standards require footnote disclosures related to fixed asset depreciation, including disclosure of depreciation methods and related useful lives by asset class, auditors perform procedures to obtain evidence that the four presentation and disclosure-related audit

objectives for depreciation are satisfied. For example, auditors compare information obtained through audit tests of the depreciation expense accounts to information disclosed in footnotes to ensure the information presented is consistent with the actual method and assumptions used to calculate and record depreciation.

5.6.6. Verify Ending Balance in Accumulated Depreciation

The debits to accumulated depreciation are normally tested as a part of the audit of disposals of assets, while the credits are verified as a part of depreciation expense. If the auditor traces selected transactions to the accumulated depreciation records in the property master file as a part of these tests, then little additional testing should be required for the ending balance in accumulated depreciation.

Two objectives are usually emphasized in the audit of the ending balance in accumulated depreciation:

1. Accumulated depreciation as stated in the property master file agrees with the general ledger. This objective can be satisfied by test-footing the accumulated depreciation in the property master file and tracing the total to the general ledger.
2. Accumulated depreciation in the master file is accurate.

In some cases, the life of equipment may be significantly reduced because of reductions in customer demands for products, unexpected physical deterioration, a modification in operations, or other changes. Because of these possibilities, auditors must evaluate the adequacy of the allowances for accumulated depreciation each year to make sure that the net book value does not exceed the realizable value of the assets.



QUICK CHECK

1. How tests classified in order to verify a fixed asset audit for instance, equipment? Clearly describe each category of tests?

5.7. Audit Approach in Relation to Fixed Assets

The detailed audit steps the auditor should cover in relation to fixed assets are the following:

1. Study and evaluate the adequacy of internal controls in relation to fixed assets.
2. Check the opening balances with those of the closing balances appearing in the audited accounts of the previous year.
3. Review the fixed assets register to ensure that the entries appearing therein are up to date.
4. Confirm that additions have been properly recorded in the fixed assets register. Additions may be by way of purchased or self-construction. In either case check the authorization documentation.
5. Check that assets scrapped or disposed of have been eliminated from the fixed assets register. Verify whether they represent valid scrapings or disposals.
6. Confirm that fixed assets have been recorded in both the fixed assets register and the relevant ledger accounts.
7. Review period reconciliations of the fixed assets register with the general ledger accounts.
8. Check whether any significant items of capital expenditure have been charged to revenue.
9. Select a sample of items and carry out physical inspection, checking from the fixed assets register to the assets and vice versa.
10. Using the sample as above, make sure that the assets are being used for the purpose of the entity's activities.
11. Review the list of additions to fixed assets during the accounting period and see whether they appear appropriate for use in the entity's activities.
12. Test a sample of additions, during the accounting period in order to ensure that the amounts recorded are in accordance with the supporting documentation.
13. Select a sample and confirm that the cost of disposals and the relevant depreciation are removed from the appropriate general ledger accounts.

14. Ensure that the basis of depreciation and the rates applied are the same as in the previous year.
15. Select a sample and test the depreciation calculations on individual assets in the fixed assets registered.
16. Verify that the entity has consistently followed its method (whether straight line, units of production level, sum-of-years digits or declining balance method) of dealing with depreciation on additions during the accounting period.
17. Obtain fixed assets summary and supporting schedules containing additions, disposals, transfers and deprecation and test with the nominal ledger and the working papers in order to confirm that they have been properly prepared.
18. Check the schedules showing expenditure on repairs.
19. Make sure that the depreciation charge is fully traced and reference to the income statement.
20. Make sure that fixed assets are properly classified and disclosed on a consistent basis.

Summary

This chapter deals with the audit of fixed assets in relation to its objectives, basic procedures, substantive tests or verifications and internal controls.

Fixed assets are those assets acquired by a business for the purpose of use in the business with the objective of earnings revenue, and which are not intended for resale at a profit and conversion into cash in the ordinary course of business.

The primary accounting record for equipment and other property, plant, and equipment accounts as a fixed asset is generally a fixed asset master file. The master file includes a detailed record for each piece of equipment and other types of property owned. The auditors' objectives in fixed asset audit are to determine that: the recorded property, plant, and equipment is valid (existence and right); all property, plant, and equipment is recorded (completeness); property, plant, and equipment records and supporting schedules are mathematically correct and agree with general ledger account (clerical accuracy); the valuation of fixed assets is proper (valuation) and the

presentation and disclosure of fixed assets , including disclosure of depreciation method, is adequate(disclosure).

The audit procedures for fixed assets are in general similar to the procedures for other items. The audit of fixed assets involves the examination of fixed assets records and evidences such as contracts, invoices, and receipt documents. In the audit of equipment as fixed asset and related accounts, it is helpful to separate the tests categorized as: Perform analytical procedures, Verify current year acquisitions, Verify current year disposals, Verify the ending balance in the asset account, Verify depreciation expense, and Verify the ending balance in accumulated depreciation

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question

1. Which of the following audit procedures is most likely to enable an auditor to discover unrecorded disposal of fixed assets?
 - A. Examination of insurance policies
 - B. Review of repairs and maintenance expense
 - C. Examination of invoice relating to additions to fixed asset
 - D. All
2. Which of the following procedures is most likely to enable an auditor to discover unrecorded additions to fixed assets?
 - A. Examination of capital budget
 - B. Review of repairs and maintenance expenses
 - C. Examination of invoice relating to additions to fixed asset
 - D. None of the above
3. Auditors verify fixed asset audit differently from current asset accounts due to:
 - A. There are usually fewer current period acquisitions of fixed assets
 - B. The amount of any given acquisition is often material.
 - C. The fixed asset is likely to be kept and maintained in the accounting records for several years
 - D. All
4. To verify the completeness of the fixed asset records, the first step to apply by the auditor is:
 - A. Examine the fixed asset register, and trace the balance to the ledger account and balance sheet.
 - B. Trace the purchase invoices during the year to fixed asset register, the ledger account and the balance sheet.

- C. Examine plant asset acquisition and disposal to make sure that these transactions are in the right period.
 - D. Both B & C
- 5. To verify the clerical accuracy of reconcile the figure of cost, accumulated depreciation and book value with the corresponding figure in the previous year end, the auditor should:
 - A. Verify calculation of depreciation
 - B. Examine the valuation of assets acquisition
 - C. Verify arithmetic accuracy of additions
 - D. Examine sales invoices and accounting records for disposal and check that depreciation is calculated to date of disposal.
 - E. All
- 6. In Perform analytical procedures for audit of fixed assets when the auditors Compare depreciation expense divided by gross equipment cost with previous years; the possible misstatement is/are:
 - A. Misstatement in depreciation expense
 - B. Accumulated depreciation
 - C. capitalized costs
 - D. A & B
- 7. The auditor's main objectives in the verification of the sale, trade-in, or abandonment of equipment are to gather sufficient appropriate evidence that all disposals are recorded and at the correct amounts.
 - A. True
 - B. False
- 8. The auditor's objectives when auditing the ending balance in the equipment accounts is to determine:
 - A. All recorded equipment physically exists on the balance sheet date (existence).
 - B. All equipment owned is recorded (completeness).
 - C. All
 - D. None

9. Which of the following method(s) the Auditors may use to determine whether a particular fixed asset is encumbered?

- A. Read the terms of loan and credit agreements
- B. Mail loan confirmation requests to banks and other lending institutions
- C. Have discussions with the client or send letters to legal counsel
- D. All

10. Periodic analysis of the scrape sales and the repairs and maintenance accounts which of the following combinations of procedures would an auditor be most likely to perform to obtain evidence about fixed asset additions?

- A. Inspection of documents and physical examination of assets.
- B. Re computation of calculations and obtaining of written management representations
- C. Observation of operating activities and comparison of balances to prior period balances.
- D. Confirmation of ownership and corroborating of transaction through inquiries of client personnel.

Part II: Essay type Questions (self-study)

Give clear and brief answers for the following questions by yourself by referring material

1. List the objectives of fixed asset audit?
2. Discuss the audit procedures used in audit of fixed assets?
3. Describe the internal control principles in audit of fixed assets?

Part III: Problem Type Questions (self-study)

Give appropriate answer for the following problems by your own self.

1. For each of the following misstatements in property, plant, and equipment accounts, state an internal control that the client can implement to prevent the misstatement from occurring and a substantive audit procedure that the auditor can use to discover the misstatement:
 - a. The asset lives used to depreciate equipment are less than reasonable, expected useful lives.

- b. Capitalizable assets are routinely expensed as repairs and maintenance, perishable tools, or supplies expense.
 - c. Acquisitions of property are recorded at incorrect amounts.
 - d. A loan against existing equipment is not recorded in the accounting records. The cash receipts from the loan never reached the company because they were used for the down payment on a piece of equipment now being used as an operating asset. The equipment is also not recorded in the records.
 - e. Computer equipment that is abandoned or traded for replacement equipment is not removed from the accounting records.
 - f. Depreciation expense for manufacturing operations is charged to administrative expenses.
 - g. Tools necessary for the maintenance of equipment are stolen by company employees for their personal use.
2. The following audit procedures were planned by Linda King, CPA, in the audit of the acquisition and payment cycle for Cooley Products, Inc.:
- 1. Review the acquisitions journal for large and unusual transactions.
 - 2. Send letters to several vendors, including a few for which the recorded accounts payable balance is zero, requesting them to inform us of their balance due from Cooley. Ask the controller to sign the letter.
 - 3. Examine a sample of receiving report numbers and determine whether each one has an initial indicating that it was recorded as an account payable.
 - 4. Select a sample of equipment listed on fixed asset master files and inspect the asset to determine that it exists and to determine its condition.
 - 5. Re-foot the acquisitions journal for 1 month and trace all totals to the general ledger.
 - 6. Calculate the ratio of equipment repairs and maintenance to total equipment and compare with previous years.
 - 7. Obtain from the client a written statement that all mortgages payable have been included in the current period financial statements and have been accurately recorded and that the collateral for each is included in the footnotes.
 - 8. Select a sample of cancelled checks and trace each one to the cash disbursements journal, comparing the name, date, and amount.

9. For 20 nontangible acquisitions, select a sample of line items from the acquisitions journal and trace each to related vendors' invoices. Examine whether each transaction appears to be a legitimate expenditure for the client and that each was approved and recorded at the correct amount and date in the journal and charged to the correct account per the chart of accounts.
10. Examine invoices and related shipping documents included in the client's unpaid invoice file at the audit report date to determine whether they were recorded in the appropriate accounting period and at the correct amounts.
11. Recalculate the portion of insurance premiums on the client's prepaid insurance schedule that is applicable to future periods.
12. When the check signer's assistant writes "paid" on supporting documents, watch whether she does it after the documents are reviewed and the checks are signed.

Required:

- A. For each procedure, identify the type of evidence being used.
- B. For each procedure, identify whether it is an analytical procedure, a test of control, substantive test of transactions, or a test of details of balances.
- C. For each test of control or substantive test of transactions, identify the transaction related audit objective(s) being met.
- D. For each test of details of balances, identify the balance-related audit objective(s) being met.

CHAPTER SIX

AUDIT OF LIABILITIES

6. LEARNING OBJECTIVES

At the end of this chapter, the learners should be able to:

Describe the objectives of both current and long-term liabilities.

Discuss the internal control principles in audit of liabilities

Understand the basic procedures taken in audit of liabilities

6.1. Introduction

Dear Learners! Liabilities or debt is one of the major sources of revenue in the real world. Every sector participates in borrowing in order to satisfy their expenses or expenditures. So, the audit of such liabilities is very essential. Liabilities are obligation of a firm which arise from past transactions and need future scarification of resources for their settlement. Liabilities can be generally classified as current or short term assets (like account payable, sales tax payable, unclaimed wages, customer's deposits, accrued liabilities, notes payable, etc.) and long term assets (like mortgage payable, bonds payable etc.).

Payables are financial obligations to be paid in the future date in connection with services or goods or money received now. Payables can be categorized into two. Short term payables are those that will be paid in the next twelve months. Long-term payables are those that will be paid after a year.

In the FGE (Federal Government of Ethiopia) accounting system, payables are classified into two. The short-terms are those that will be paid in the next budget year. This includes payables arising from receipt of goods and services; payables among Public Bodies, to or by Regions and to employees; short-term domestic loan taken by the Government; deposits received that will be paid when certain conditions are fulfilled (like court deposit); and retentions from payments to contractors. Long-term payables are those that will not be paid in the next budget year. Foreign loan is one of the significant long-term payables.

In this chapter we presented the audit objectives and audit procedures for account payable and notes payable, accrued liabilities and long term liabilities were discussed as below.

6.2. Audit of Account Payable

Account payables are obligations for the acquisition of raw materials, equipment, utilities, repairs, advertising, and many other types of goods and services that were received before the end of the year and are to be settled with in a fiscal year. Interest-bearing obligations should not be included in account payable. If an obligation includes the payment of interest, it should be recorded properly as a note payable, contract payable or bond.

Accounts payable includes obligations for the acquisition of raw materials, equipment, utilities, repairs, and many other types of goods and services that were received before the end of the year. Most accounts payable can also be identified by the existence of vendors' invoices for the obligation. Accounts payable should be distinguished from accrued liabilities and interest bearing obligations. A liability is an account payable only if the total amount of the obligation is known and owed at the balance sheet date. If the obligation includes the payment of interest, it should be recorded as a note payable, contract payable, mortgage payable, or bond payable.

If tests of controls and related substantive tests of transactions show that controls are operating effectively, and if analytical procedures results are satisfactory, the auditor is likely to reduce tests of details of balances for accounts payable. However, because accounts payable tend to be material for most companies, auditors almost always perform some tests of details of balances.

The recent focus by many companies on improving their supply-chain management activities has led to numerous changes in the design of systems used to initiate and record acquisition and payment activities. Efforts to streamline the purchasing of goods and services, including greater emphasis on just-in-time inventory purchasing, increased sharing of information with suppliers, and the use of technology and e-commerce to transact business, are changing all aspects of the acquisition and payment cycle for many companies. These arrangements and systems can be complex.

Significant client business risks may arise from these changes. For example, suppliers may have greater access to accounts payable records, allowing them to continually monitor the status of

payable balances and to perform detailed reconciliations of transactions. Access by external parties, such as suppliers, to accounting records threatens the likelihood of misstatement if that access is not properly controlled. Also, increased focus on improving the logistics of physically moving inventory throughout a company's distribution chain may increase the difficulty of establishing effective cutoff of accounts payable balances at year-end. The auditor needs to understand the nature of changes to these systems to identify whether client business risks and related management controls affect the likelihood of material misstatements in accounts payable.

6.2.1. Audit Objectives of Account Payable

The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements. The auditors should consider the following audit objectives in an audit of account payable:

1. Consider **internal control** over account payable
2. Determine the **existence** of recorded accounts payable and that the client has obligations to pay these liabilities.
3. Establish the **completeness** of recorded accounts payable
4. Establish the **clerical accuracy** of records and supporting schedules of account payable
5. Determine the **valuation** of accounts payable is in accordance with GAAP.
6. To determine the **presentation and disclosure** of account payable are appropriate

QUICK CHECK

1. Define account payable for the purpose of audit?
2. List and describe the objectives of account payable audit?

6.2.2. Audit Approach in Relation to Accounts Payables

The following are some of the audit procedures used in testing transactions related to accounts payable:

Trace individual vendor's invoices to master file for names and amounts

Trace the total to the general ledger

Confirm that all accounts payable related transactions are properly recorded
Confirm that all recorded account payable transactions are valid and occurred
Review statements to make sure that long term and interest bearing notes are segregated.

QUICK CHECK

1. Discuss the approaches in relating to account payable audit?

6.2.3. Internal control and verification in audit of Account Payable

Like accounts receivable, a large number of transactions can affect accounts payable. The balance is often large and made up of a large number of vendor balances and it is relatively expensive to audit the account. For these reasons, auditors typically set tolerable misstatement for accounts payable relatively high. For the same reasons, auditors often assess inherent risk as medium or high. They are especially concerned about the completeness and cutoff balance-related audit objectives because of the potential for understatements in the account balance. After auditors set tolerable misstatement and inherent risk for accounts payable, they assess control risk based on an understanding of internal control.

The auditor's ultimate substantive tests depend on the relative effectiveness of internal controls related to accounts payable. Therefore, auditors must have a thorough understanding of how these controls relate to accounts payable.

The effects of the client's internal controls on accounts payable tests can be illustrated by two examples:

1. Assume that the client has highly effective internal controls over recording and paying for acquisitions. The receipt of goods is promptly documented by pre-numbered receiving reports; pre-numbered vouchers are promptly and efficiently prepared and recorded in the acquisition transactions file and the accounts payable master file. Cash disbursements are made promptly when due and immediately recorded in the cash disbursements transactions file and the accounts payable master file. Individual accounts payable balances in the master file are reconciled monthly with vendors' statements, and the computer automatically reconciles the master file total to the general ledger. Under these

circumstances, the verification of accounts payable should require little audit effort once the auditor concludes that internal controls are operating effectively.

2. Assume that receiving reports are not used; the client defers recording acquisitions until cash disbursements are made and because of cash shortages, bills are often paid several months after their due date. When an auditor faces such a situation, there is a high likelihood of an understatement of accounts payable; therefore, extensive tests of details of accounts payable are necessary to determine whether accounts payable is correctly stated on the balance sheet date.

In addition to those controls, each month an independent person or computer program should reconcile vendors' statements with recorded liabilities and the accounts payable master file with the general ledger. After assessing control risk, the auditor designs and performs tests of controls and substantive tests of transactions for acquisitions and cash disbursements.

The use of analytical procedures is as important in the acquisition and payment cycle as it is in every other cycle, especially for uncovering misstatements in accounts payable. Auditors should compare current year expense totals with prior years to uncover misstatements of accounts payable as well as in the expense accounts. Because of double-entry accounting, a misstatement of an expense account usually also results in an equal misstatement of accounts payable. Therefore, comparing current expenses such as rent, utilities, and other regularly scheduled bills with prior years is an effective procedure for analyzing accounts payable when expenses from year to year are expected to be relatively stable.

The overall objective in the audit of accounts payable is to determine whether the accounts payable balance is fairly stated and properly disclosed. Seven of the eight balance-related audit objectives are applicable to accounts payable: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations. Realizable value is not applicable to liabilities.

There is an important difference in emphasis in the audit of liabilities and assets.

When auditors verify assets, they emphasize overstatements through verification by confirmation, physical examination, and examination of supporting documents. The opposite approach is taken in verifying liability balances; that is, the main focus is on understated or omitted liabilities.

The difference in emphasis in auditing assets and liabilities results directly from the legal liability of CPAs. If equity investors, creditors, and other users determine subsequent to the issuance of the audited financial statements that earnings and owners' equity were materially overstated, a lawsuit against the CPA firm is fairly likely. Because an overstatement of owners' equity can arise either from an overstatement of assets or an understatement of liabilities, it is natural for CPAs to emphasize those two types of misstatements. Auditors should not ignore the possibility that assets are understated or liabilities are overstated, and should design tests to detect material understatements of earnings and owners' equity, including those arising from material overstatements of accounts payable.

We can use the same balance-related audit objectives applied to verifying accounts receivable, as they also apply to liabilities, with three minor modifications:

1. The realizable value objective is not applicable to liabilities. Realizable value applies only to assets.
2. The rights aspect of the rights and obligations objective is not applicable to liabilities. For assets, the auditor is concerned with the client's rights to the use and disposal of the assets. For liabilities, the auditor is concerned with the client's obligations for the payment of the liability. If the client has no obligation to pay a liability, it should not be included as a liability.
3. For liabilities, there is emphasis on the search for understatements rather than for overstatements, as we just discussed.

The auditor's actual audit procedures vary considerably depending on the nature of the entity, the materiality of accounts payable, the nature and effectiveness of internal controls, and inherent risk. As auditors perform test of details of balances for accounts payable and other liability accounts they may also gather evidence about the four presentations and disclosure objectives, especially when performing completeness objective tests. Other procedures related to presentation and disclosure objectives are done as part of procedures to complete the audit.

QUICK CHECK

1. Discuss the internal control mechanisms in an audit of account payable?

6.2.3. Account payable audit and test procedures

Out-of-Period Liability Tests: Because of the emphasis on understatements in liability accounts, out-of-period liability *tests* are important for accounts payable. The extent of tests to uncover unrecorded accounts payable, often called the search for unrecorded accounts payable, depends heavily on assessed control risk and the materiality of the potential balance in the account. The same audit procedures used to uncover unrecorded payables are applicable to the accuracy objective. The following are typical audit procedures:

Examine Underlying Documentation for Subsequent Cash Disbursements: Auditors examine supporting documentation for cash disbursements subsequent to the balance sheet date to determine whether a cash disbursement was for a current period liability. If it is a current period liability, the auditor should trace it to the accounts payable trial balance to make sure it is included. The receiving report indicates the date inventory was received and is therefore an especially useful document. Similarly, the vendor's invoice usually indicates the date services were provided. Auditors often examine documentation for cash disbursements made in the subsequent period for several weeks after the balance sheet date, especially when the client does not pay bills on a timely basis.

Examine Underlying Documentation for Bills Not Paid Several Weeks After the Year End: Auditors carry out this procedure in the same manner as the preceding one and for the same purpose. This procedure differs in that it is done for unpaid obligations near the end of the audit rather than for obligations that have already been paid.

Trace Receiving Reports Issued Before Year-End to Related Vendors' Invoices: All merchandise received before the year-end of the accounting period should be included as accounts payable. By tracing receiving reports issued up to year-end to vendors' invoices and making sure that they are included in accounts payable, the auditor is testing for unrecorded obligations.

Trace Vendors' Statements That Show a Balance Due to the Accounts Payable Trial Balance: If the client maintains a file of vendors' statements; auditors can trace any statement that has a balance due at the balance sheet date to the listing to make sure it is included as an account payable.

Send Confirmations to Vendors with Which the Client Does Business :Although the use of confirmations for accounts payable is less common than for accounts receivable, auditors use them occasionally to test for vendors omitted from the accounts payable list, omitted transactions, and misstated account balances. Sending confirmations to active vendors for which a balance has not been included in the accounts payable list is a useful means of searching for omitted amounts. This type of confirmation is commonly called a zero balance confirmation.

Cutoff Tests: Accounts payable cutoff tests are done to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period. The five out-of-period liability audit tests we just discussed are all cutoff tests for acquisitions, but they emphasize understatements. For the first three procedures, it is also appropriate to examine supporting documentation as a test of overstatement of accounts payable. For example, the third procedure tests for understatements (unrecorded accounts payable) by tracing receiving reports issued before year-end to related vendors 'invoices. To test for overstatement cutoff amounts, the auditor should trace receiving reports issued after year-end to related invoices to make sure that they are not recorded as accounts payable (unless they are inventory in transit, which is discussed shortly).

Relationship of Cutoff to Physical Observation of Inventory: In determining that the accounts payable cutoff is correct, it is essential that the cutoff tests be coordinated with the physical observation of inventory. The cutoff information for acquisitions should be obtained during the physical observation of inventory. At that time, the auditor should review the procedures in the receiving department to determine that all inventory received was counted, and the auditor should record in the audit documentation the last receiving report number of inventory included in the physical count. Subsequent to the physical count date, the auditor should then test the accounting records for cutoff. The auditor should trace the previously documented receiving report numbers to the accounts payable records to verify that they are correctly included or excluded.

Inventory in Transit: In accounts payable, auditors must distinguish between acquisitions of inventory that are on an **FOB destination** basis and those that are made

FOB origin. For FOB destination, title passes to the buyer when the inventory is received; so only inventory received on or before the balance sheet date should be included in inventory and accounts payable at year-end. When an acquisition is FOB origin, the company must record the inventory and related accounts payable in the current period if shipment occurred on or before the balance sheet date.

Auditors can determine whether inventory has been acquired FOB destination or origin by examining vendors' invoices. Auditors should examine invoices for merchandise received shortly after year-end to determine whether they were on an FOB origin basis. For those that were, and when the shipment dates were on or before the balance sheet date, the inventory and related accounts payable must be recorded in the current period if the amounts are material.

QUICK CHECK

1. Describe the procedures employed by the auditors in an audit of account payable?
2. List the major tests taken in verification of account payable

5.3. Audit of Note Payable

A note payable is a legal obligation of entities that includes interest and requires the written promise of the maker. A note is issued for a period between one month and one year, and even for more than a year- are called long term notes.

6.3.1. Audit Objectives of Notes Payable

The auditor's objectives in examination of notes payable are summarized in to the following three major objectives:

1. The internal control over notes payable is adequate

In evaluating the internal control over notes payable the auditors should consider the following:

- a. Proper authorization for the issue of new notes: Responsibility for the issuance of new notes should be vested in the board of director or higher level management. The

agreement should contain the amount of the loan, the interest rate and the repayment terms.

- b. Adequate control over the repayment of the principal and interest: The periodic payments of interest and principal should be controlled. When the note is issued a copy should be sent to the accounting department for proper recording
- c. Proper documents and recorded: This includes maintenance of subsidiary records and use of appropriate documents: Periodic independent verification

The details of the note records should be reconciled with the general ledger and compared with the note holders' records by an employee who is not responsible for maintaining the detailed records.

- 2. Transaction for principal and interest involving notes are properly authorized and recorded.
- 3. The liability for notes payable and the related interest expenses and accrued liabilities are properly stated in the financial statements.

6.3.2. Audit Approach in Relation to Notes Payable

Notes payable transactions involve the issue of notes and the repayment of principal and interest. The following are some of the audit procedures used in testing transactions related to notes payable.

Obtain a schedule of notes payable and accrued interest a schedule usually includes detailed information of all transactions that have been taken place during the entire year for the principal and interest, the beginning and ending balances of notes and interest payable, and descriptive information about the notes, such as the due date and the interest rate

Confirm that all existing notes payable are included

Confirm that notes payables are properly valued

Confirm that notes payable are properly disclosed.

QUICK CHECK

1. List the objective of notes payable audit?
2. Describe procedures used in testing transactions related to notes payable?

6.4. Audit of accrued liabilities

Many accrued liabilities represent future obligations for unpaid services resulting from the passage of time but are not payable at the balance sheet date. For example, the benefits of property rental accrue throughout the year. Therefore, at the balance sheet date, a certain portion of the total rent cost that has not been paid should be accrued. Other similar liabilities include:

Accrued payroll

Accrued professional

fees Accrued payroll

taxes Accrued rent

Accrued officers' bonuses

Accrued interest

Accrued commissions

The following discussion of the audit of accrued property taxes is used as an example of the audit of an accrued liability account.

6.4.1. Auditing Accrued Property Taxes

As with insurance expense, the balance in property tax expense is a residual amount that results from the beginning and ending balances in accrued property taxes and the payments of property taxes. Therefore, the emphasis in the tests should be on the ending property tax liability and payments. When auditors verify accrued property taxes, all eight balance-related audit objectives except realizable value are relevant. Two are especially significant:

1. Existing properties for which accrual of taxes is appropriate are on the accrual schedule. The failure to include properties for which taxes should be accrued will understate the property tax liability (completeness). A material misstatement can occur, for example, if

taxes on property were not paid before the balance sheet date and not included as accrued property taxes.

2. Accrued property taxes are accurately recorded. The auditor's concern is the consistent treatment of the accrual from year to year (**accuracy**).

The auditor uses two primary tests for the inclusion of all accruals. Auditors verify the accruals at the same time as the audit of current year property tax payments. In most audits, there are few property tax payments, but each payment is often material, and therefore it is common to verify each one. Auditors also compare the accruals with those of previous years.

The auditor often begins by obtaining a schedule of property tax payments from the client and comparing each payment with the preceding year's schedule to determine whether all payments have been included in the client-prepared schedule. The fixed asset audit schedules also must be examined for major additions and disposals of assets that may affect the property taxes accrual. All property affected by local property tax regulations should be included in the schedule, even if the first tax payment has not yet been made.

After auditors are satisfied that all taxable property has been included in the client prepared schedule, they evaluate the reasonableness of property taxes on each property used by the client to estimate the accrual. In some instances, the total has already been set by the taxing authority and sent to the client so it is possible to verify the amount by comparing the amount on the schedule with the tax bill. In other cases, the preceding year's total payments must be adjusted for the expected increase in property tax rates.

The auditor can verify the accrued property tax by recalculating the portion of the total tax applicable to the current year for each piece of property. The most important consideration is to use the same portion of each tax payment for the accrual that was used in the preceding year, unless there are justifiable conditions for a change. After the accrual and property tax expense for each piece of property have been recalculated, the totals should be added and compared with the general ledger. In many cases, property taxes are charged to more than one expense account. In that case, the auditor should test for correct classification by evaluating whether the correct amount was charged to each account.

QUICK CHECK

1. Examine the audit procedures and tests in audit of accrued liabilities?

6.5. Audit of long term liabilities

6.5.1. Audit objectives to long term liabilities

In carrying out an audit of liabilities, the auditor seeks to obtain sufficient appropriate audit evidence to reasonably assure him/her in respect of the following assertions:

Existence: The obligations in respect of liabilities shown on the balance sheet are outstanding at the balance sheet date.

Right and obligation: liabilities represents obligation of the enterprise to the third parties

Completeness: the outstanding obligation the third parties are included in liabilities shown in the balance sheet

Valuation : liabilities are stated in the financial statement at appropriate amounts

Presentation and disclosure: liabilities are classified and disclosed in the financial statement in accordance with recognized accounting principles and relevant statutory requirements.

6.5.2. Internal control principles for long term liabilities

The auditor evaluates the accounting system and internal control relating to loans and borrowing aspects focusing on the following;

1. The term relating to loan and borrowing to ensure if it covers the following aspects:

Interest, securely, repayment, etc.

Maximum amount up to which a loan or a borrowing can authorize the acceptance of loan or borrowing along with the limit on the amount of all loans and borrowing;

Procedures for negotiating the term; the person who can be authorize the acceptance of loan or borrowing along with the limit on the amount

Documentation ,i.e agreements and there documents to be executed for different kind of loans and borrowing

Procedures for ensuring compliance with the relevant legal requirements

2. The availability of proper system for safe custody of document relating to loans and borrowing
3. The availability of a system of periodic review of the condition and value of securities offered.
4. The availability of system of obtaining periodic confirmation of balance relating to each loan and borrowing. The auditor should also check if the discrepancies revealed by such confirmation investigated and appropriate follow up action taken.
5. The auditor should also ascertain if there is a periodic review of all loans and borrowing to identify case where the enterprise has failed to comply with the term and conditions, particularly those where the ammos of principal and or inter have become overdue.

6.5.3. Audit procedures for long term liabilities

The following specific procedures are employed in auditing of long term liabilities.

1. Examine whether the total amount of liabilities is within the statutory or other limit on the limit on the borrowing power.
2. Examine the relevant agreement and other documents supporting the transactions relating to loan, borrowing, etc. in particular, the auditors has to examine the following.
Are important terms of loan agreement being complied with? The auditors pay particular attention to those terms which affects the financial statements and examines whether these requirements or restrictions have been complied with.

In the case loan classified as secured, is the market value of the security as at the balance sheet date at least equal to the amount of the loan outstanding?

In the case of loans and advances from bank and financial institution, do the amounts shown as outstanding agree with the statement of account/ confirmation received from the lender? In the case of discrepancy, has reconciliation been carried out between the amount shown in the book of the company and that shown in the statement of the lender? Similarly, have confirmation of balance been obtained from other providers of loan and advances and the difference, if any duly reconciled?

3. Examine any specific aspects relating to loans and borrowing which are required to be examined or reported up on under the status governing the company
4. In the case of bonds issued by a company, you have to carry out the following procedure.
 - A. Verify the opening balance of bonds with the amount shown in the audited balance sheet of the previous year.
 - B. In respect of bond issued during the year, examine the memorandum and the articles of association of the company as well as the relevant resolution of the board of directors and where relevant of the general meeting, authorized the issue of bonds.
5. Examine whether the loan s and borrowing have been properly classified in the financial statement in accordance with recognized accounting principles.

QUICK CHECK

1. Innumerate the objectives of long-term liabilities?
2. Discuss the internal control of long term liability audit?
3. Describe the procedures taken in audit of long term liabilities?

Summary

So far, under this chapter we have seen audit of both current liabilities and long term liabilities in respect to its objectives, internal control, and procedures.

Liabilities are obligation of a firm which arises from past transactions and need future scarification of resources for their settlement. In the FGE (Federal Government of Ethiopia) accounting system, payables are classified into two. The short-terms are those that will be paid in the next budget year. This includes payables arising from receipt of goods and services; payables among Public Bodies, to or by Regions and to employees; short-term domestic loan taken by the Government; deposits received that will be paid when certain conditions are fulfilled (like court deposit); and retentions from payments to contractors. Long-term payables are those that will not be paid in the next budget year. Foreign loan is one of the significant long-term payables.

The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements. Seven of the eight balance-related audit objectives are applicable to accounts payable: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations. Realizable value is not applicable to liabilities. Some of the audit procedures used in testing transactions related to accounts payable are: trace individual vendor's invoices to master file for names and amounts; trace the total to the general ledger; confirm that all accounts payable related transactions are properly recorded; confirm that all recorded account payable transactions are valid and occurred and review statements to make sure that long term and interest bearing notes are segregated.

The auditor's objectives in examination of notes payable are: the internal control over notes payable is adequate; transaction for principal and interest involving notes are properly authorized and recorded and the liability for notes payable and the elated interest expenses and accrued liabilities are properly stated in the financial statements. In carrying out an audit of long term liabilities, the auditor seeks to obtain sufficient appropriate audit evidence to reasonably assure him/her in respect of the following assertions: Existence, Right and obligation, Completeness, Valuation and Presentation and disclosure.

Finally, you can understand the definition of payables, audit procedures and verification procedures in an audit of liabilities or payables in Ethiopia and audit of letter of credit.

SELF ASSESSEMENT QUESTIONS

Part I: True or False Questions

Write true if the statement is correct and false if the statement is incorrect.

1. Payables are financial obligations to be paid in the future date in connection with services or goods or money received now.
2. The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements.
3. The auditor's ultimate substantive tests taken depend on the relative effectiveness of internal controls related to accounts payable.
4. Accounts payable cutoff tests are done to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period.
5. In carrying out an audit of liabilities, the auditor doesn't obligate seeks to obtain sufficient appropriate audit evidence.
6. The auditor evaluates the accounting system and internal control relating to loans and borrowing in an audit of long term liabilities.

Part II: Multiple Choice Questions

Choose the correct answer among the given alternatives

1. The auditor's actual audit procedures in audit of account payable vary considerably depending on:
 - A. the nature of the entity
 - B. the materiality of accounts payable,
 - C. the nature and effectiveness of internal controls
 - D. inherent risk
 - E. All
2. The auditor's objectives in examination of notes payable are:
 - A. Evaluating the internal control over notes payable is adequate.
 - B. Checked out the transaction for principal and interest involving notes are properly authorized and recorded.

- C. To proof the liability for notes payable and the elated interest expenses and accrued liabilities are properly stated in the financial statements.
 - D. All
3. Which of the following procedures is least likely to be completed before the balance sheet date?
- A. Confirmation of receivables
 - B. Search for unrecorded liabilities
 - C. Observation of inventory
 - D. Review of internal accounting control over cash disbursement
4. An audit of the balance sheet in account payable account is ordinarily not designed to:
- A. Detect account payable that are substantially past due
 - B. Verify account payable were properly authorized
 - C. Ascertain the reasonable of recorded liabilities
 - D. Ascertain that all existing liabilities at the balance sheet date have been recorded.
5. Which of the following is the best audit procedure for determining the existence of unrecorded liabilities?
- A. Examine confirmation request returned by creditors
 - B. Examine unusual relationship between monthly account payable balance and recorded purchase
 - C. Examine sample invoice a few day prior to and subsequent to year end to ascertain whether they have been properly recorded.
 - D. Examine selected cash disbursement in the period subsequent to year end.
6. Auditors confirmation of account payable balance at the balance sheet date may be unnecessary because :
- A. This is duplication of cutoff tests
 - B. Account payable balance at the balance sheet date may not be paid before the audit is completed
 - C. Correspondence with the audit clients' attorney will reveal all legal action by vendors for nonpayment.
 - D. There is likely to be other reliable external evidence available to support the balance.

Part III: Short answer and Essay type Questions (self-study)

Give clear and precise answers for the following questions by your own referring the material.

1. Describe the audit approaches in relating to notes payable?
2. Innumerate Audit objectives to long term liabilities?
3. Discuss the internal control principles for long term liabilities?
4. Describe the audit procedures taken in audit of long term liabilities?

Part IV: Problem type Questions (self-study)

Forward the answers for the following questions

1. Items 1 through 6 are questions typically found in a standard internal control questionnaire used by auditors to obtain an understanding of internal control for notes payable. In using the questionnaire for a client, a “yes” response indicates possible internal control, whereas a “no” indicates a potential deficiency.
1. Are liabilities for notes payable incurred only after written authorization by a proper company official?
2. Is a notes payable master file maintained?
3. Is a periodic reconciliation made of the notes payable master file with the actual notes outstanding by an individual who does not maintain the master file?
4. Is the individual who maintains the notes payable master file someone other than the person who approves the issue of new notes or handles cash?
5. Are paid notes cancelled and retained in the company files?
6. Are interest expense and accrued interest recomputed periodically by an individual who does not record interest transactions?

Required:

- A. For each of the preceding questions, state the purpose of the control.
 - B. For each of the preceding questions, identify the type of financial statement misstatement that can occur if the control were not in effect.
 - C. For each of the potential misstatements in part b, list an audit procedure that can be used to determine whether a material misstatement exists.
2. The ending general ledger balance of \$186,000 in notes payable for the Sterling Manufacturing Company is made up of 20 notes to eight different payees. The notes vary

in duration anywhere from 30 days to 2 years, and in amounts from \$1,000 to \$10,000. In some cases, the notes were issued for cash loans; in other cases, the notes were issued directly to vendors for the acquisition of inventory or equipment. The use of relatively short-term financing is necessary because all existing properties are pledged for mortgages. Nevertheless, there is still serious cash shortage. Record-keeping procedures for notes payable are not good, considering the large number of loan transactions. There is no notes payable master file or independent verification of ending balances; however, the notes payable records are maintained by secretary who does not have access to cash. The audit has been done by the same CPA firm for several years. In the current year, the following procedures were performed to verify notes payable:

1. Obtain a list of notes payable from the client, foot the notes payable balances on the list, and trace the total to the general ledger.
2. Examine duplicate copies of notes for all outstanding notes included on the listing. Compare the name of the lender, amount, and due date on the duplicate copy with the list.
3. Obtain a confirmation from lenders for all listed notes payable. The confirmation should include the due date of the loan, the amount, and interest payable at the balance sheet date.
4. Re-compute accrued interest on the list for all notes. The information for determining the correct accrued interest is to be obtained from the duplicate copy of the note. Foot the accrued interest amounts and trace the balance to the general ledger.

Required:

- A. What should be the emphasis in the verification of notes payable in this situation? Explain.
- B. State the purpose of each of the four audit procedures listed.
- C. Evaluate whether each of the four audit procedures was necessary. Evaluate the sample size for each procedure.
- D. List other audit procedures that should be performed in the audit of notes payable in these circumstances.

CHAPTER SEVEN

AUDIT OF DEBT AND EQUITY

7. LEARNING OBJECTIVES

At the end of this chapter, learners will able to:

Understand the objectives and procedures in an audit of owners' equity

Describe the internal control of owners' equity audit

Understand equity audit procedures in partnership and corporation

Examine audit procedures of retained earnings and dividends

7.1. Introduction

Dear Learners! Equity refers to the net worth of the business, i.e. the amount remaining after deducting total liabilities from total assets. It consists of capital stocks (preferred stock and common stock), paid in capital, dividends, and retained earnings.

There is an important difference in the audit of owners' equity between a publicly held corporation and a closely held corporation. In most closely held corporations, which typically have few shareholders, occasional, if any, transactions occur during the year for capital stock accounts. The only transactions entered in the owners' equity section are likely to be the change in owners' equity for the annual earnings or loss and the declaration of dividends, if any. Closely held corporations rarely pay dividends, and auditors spend little time verifying owners' equity, even though they must test the corporate records. For publicly held corporations, however, the verification of owners' equity is more complex because of the larger numbers of shareholders and frequent changes in the individuals holding the stock. The rest of this chapter deals with tests for verifying the major owners' equity accounts in a publicly held corporation, including: Capital and common stock, Paid-in capital in excess of par and Retained earnings and related dividends.

The objective for each is to determine whether: Internal controls over capital stock and related dividends are adequate; Owners' equity transactions are correctly recorded, as defined by the six transaction-related audit objectives; Owners' equity balances are properly recorded, as defined by the eight balance related audit objectives, and properly presented and disclosed, as defined by the four presentation and disclosure-related audit objectives for owners' equity accounts. Other

accounts in owners' equity are verified in much the same way as these. Then, this chapter dealt with the objectives, procedures, internal control of equity audit in general and stock audit in Ethiopia.

7.2. Internal Controls in audit of owners' equity

Several internal controls are important for owners' equity activities. We discuss several of these in the following sections.

Proper Authorization of Transactions: Because each owner's equity transaction is typically material, many of these transactions must be approved by the board of directors. ***Issuance of Capital Stock.*** The authorization includes the type of equity to issue (such as preferred or common stock), number of shares to issue, par value of the stock, privileged condition for any stock other than common, and date of the issue.

Repurchase of Capital Stock. The repurchase of common or preferred shares, the timing of the repurchase, and the amount to pay for the shares should all be approved by the board of directors.

Declaration of Dividends. The board of directors must authorize the form of the dividends (such as cash or stock), the amount of the dividend per share, and the record and payment dates of the dividends.

Proper Record Keeping and Segregation of Duties: When a company maintains its own records of stock transactions and outstanding stock, the internal controls must be adequate to ensure that:

Actual owners of the stock are recognized in the corporate records

The correct amount of dividends is paid to the stockholders owning the stock as of the dividend record date

The potential for misappropriation of assets is minimized

The proper assignment of personnel, adequate record-keeping procedures, and independent internal verification of information in the records are useful controls for these purposes. The client should also have well-defined policies for preparing stock certificates and for recording capital stock transactions.

When issuing and recording capital stock, the client must comply with both the state laws governing corporations and the requirements in the corporate charter. The par value of the stock, the number of shares the company is authorized to issue and state taxes on the issue of capital stock all affect issuance and recording.

As a control over capital stock, most companies maintain stock certificate books and a shareholders' capital stock master file. A capital stock certificate record records the issuance and repurchase of capital stock for the life of the corporation. The record for a capital stock transaction includes the certificate number, the number of shares issued, the name of the person to whom it was issued, and the issue date. When shares are repurchased, the capital stock certificate book should include the cancelled certificates and the date of their cancellation.

A shareholders' capital stock master file is the record of the outstanding shares at any given time. The master file acts as a check on the accuracy of the capital stock certificate record and the common stock balance in the general ledger. It is also used as the basis for the payment of dividends.

Internal controls affecting dividend payments may include:

- Dividend checks are prepared from the capital stock certificate record by someone who is not responsible for maintaining the capital stock records.

- After the checks are prepared, there is independent verification of the stockholders' names and the amounts of the checks and a reconciliation of the total amount of the dividend checks with the total dividends authorized in the minutes.

- A separate impress dividend account is used to prevent the payment of a larger amount of dividends than was authorized.

Independent Registrar and Stock Transfer Agent: Any company with stock listed on a securities exchange is required to engage an *independent registrar* as a control to prevent the improper issue of stock certificates.

The responsibility of an independent registrar is to make sure that stock is issued by a corporation in accordance with the capital stock provisions in the corporate charter and the authorization of the board of directors. When there is a change in the ownership of the stock, the registrar is responsible for signing all newly issued stock certificates and making sure that old certificates are received and cancelled before a replacement certificate is issued.

Most large corporations also employ the services of a **stock transfer agent** to maintain the stockholder records, including those documenting transfers of stock ownership. The employment of a transfer agent helps strengthen control over the stock records by putting the records in the hands of an independent organization and helps reduce the cost of record keeping by using a specialist. Many companies also have the transfer agent disburse cash dividends to shareholders, further improving internal control.

7.3 Audit procedures for stockholders Equity (Corporation)

As any change in share capital is likely to be a material transaction which is subjected to special legal requirements, changes should be checked. The main procedures employed by the auditors in stockholders equity are listed below.

- Obtain an understanding of internal control over capital stock transactions.

 - Review the articles of incorporation by law and minutes for provisions relating to capital stock.

- Obtain and prepare analysis of the capital stock account.

 - Check authorized capital limit to legislation and company constitutions documents. Check changes to issue capital in year and agree to board minutes.

- Trace all transactions involving cash to the book and bank statement.

 - Ensure that any necessary registration has been made and that the company's register of members has been updated.

 - For a corporation acting as its own stock register and transfer agent, reconcile the stock records with the general ledger.

- Ensure appropriate disclosure as either debt or equity.

 - Ensure that all transactions are legal and that premium in particular has been accounted for properly.

7.4 Procedures for audit partners' account

A most significant document underlying the partnership form of organization is the partnership contract. You will be particularly interested in determine that the distribution of net income has been carried out in accordance with the profit sharing provision of the partnership contract. You have to verify whether partners' capital account are maintained at prescribed levels and

restriction of drawing by partners to specify amounts are according to the partnership contracts. You should be comparing the partner's loan account with the partnership contract to determine the treatment by the partners.

Occasionally, you may find that a partnership is operating without any written agreement of partnership. This situation raises a question of whether profit have been divided in accordance with the underlying existing between the partners. You may obtain from each partner written statements confirming the balance in his/her capital account and approval of the method used in dividing the year's earning.

In general, the same principles described for the audit of corporate capital are applicable to the examination of the capital account and drawing accounts of sole proprietorship .the following are the major audit procedures in auditing owners' equity of sole proprietorship or partnership.

- Analyze all accounts from beginning of the business

- Trace the initial capital investment and any addition to the cash and asset records

- Verify the net income or loss for the period and any withdrawals are verified.

7.5. Audit of Capital Stock and Paid in Capital

Auditors have four main concerns in auditing capital stock and paid-in capital in excess of par:

1. Existing capital stock transactions are recorded (completeness transaction-related objective).
2. Recorded capital stock transactions occurred and are accurately recorded (occurrence and accuracy transaction-related objectives).
3. Capital stock is accurately recorded (accuracy balance-related objectives).
4. Capital stock is properly presented and disclosed (all four presentation and disclosure objectives).

The first two concerns involve tests of controls and substantive tests of transactions, and the last two involve tests of details of balances and related disclosures.

7.5.1. Objectives of capital stock Audit

1. Existing Capital Stock Transactions Are Recorded: This objective is easily satisfied when a registrar or transfer agent is used. The auditor can confirm with them whether any capital stock transactions occurred and the accuracy of existing transactions and then determine if all of

those transactions have been recorded. To uncover issuances and repurchases of capital stock, auditors also review the minutes of the board of directors meetings, especially near the balance sheet date, and examine client-held stock record books.

2. Recorded Capital Stock Transactions Occurred and Are Accurately Recorded:

Extensive auditing is required for transactions involving issuance of capital stock such as the issuance of new capital stock for cash, the merger with another company through an exchange of stock, donated shares, and the purchase of treasury shares. Regardless of the controls, it is normal practice for auditors to verify all capital stock transactions because of their materiality and permanence in the records. The occurrence transaction-related objective can ordinarily be tested by examining the minutes of the board of directors meetings for proper authorization.

Auditors can readily verify accurate recording of capital stock transactions for cash by confirming the amount with the transfer agent and tracing the amount of the recorded capital stock transactions to cash receipts. (In the case of treasury stock, the amounts are traced to the cash disbursements journal.) In addition, the auditor must verify whether the correct amounts were credited to capital stock and paid-in capital in excess of par by referring to the corporate charter to determine the par or stated value of the capital stock.

Auditing capital stock transactions such as stock dividends, acquisition of property for stock, mergers, or similar noncash transfers is challenging because considerable technical expertise is required and there is often judgment involved to determine proper valuations. For example, in the audit of a major merger transaction, the auditor must often do considerable research to determine the appropriate accounting treatment and proper valuation of the transaction, after considering all the facts in the merger.

- 3. Capital Stock Is Accurately Recorded:** Auditors verify the ending balance in the capital stock account by first determining the number of shares outstanding at the balance sheet date. A confirmation from the transfer agent is the simplest way to obtain this information. When no transfer agent exists, the auditor must rely on examining the stock records and accounting for all shares outstanding in the stock certificate records, examining all cancelled certificates, and accounting for blank certificates.

After the auditor is satisfied that the number of shares outstanding is correct, the recorded par value in the capital account can be verified by multiplying the number of shares by the par value of the stock. The ending balance in the capital in excess of par account is a residual amount. It is audited by verifying the amount of recorded transactions during the year and adding them to or subtracting them from the beginning balance in the account.

A major consideration when auditing the accuracy balance-related objective for capital stock is verifying whether the number of shares used in the calculation of earnings per share is accurate. It is easy to determine the correct number of shares to use in the calculation when there is only one class of stock and a small number of capital stock transactions. The problem becomes much more complex when there are convertible securities, stock options, or stock warrants outstanding. Auditors must have thorough understanding of requirements of relevant accounting standards before verifying the number of shares for determining basic and diluted earnings per share.

4. Capital Stock Is Properly Presented and Disclosed: The most important sources of information for determining whether all four presentation and disclosure-related objectives for capital stock activities are satisfied are the corporate charter, the minutes of board of directors meetings, and the auditor's analysis of capital stock transactions.

The auditor should determine that each class of stock has a proper description, including the number of shares issued and outstanding and any special rights of an individual class. Auditors should also verify the proper presentation and disclosure of stock options, stock warrants, and convertible securities by examining legal documents or other evidence of the provisions of these. To sum up, the auditor's objectives in examination of owners Capital Stock and Paid In Capital are:

1. To determine whether the internal control over owners' equity is adequate. This includes determining whether there is:
 - a. Proper authorization of transactions – for issuance of stock, repurchasing of capital stock, and declaration of dividend.
 - b. Proper record keeping of capital stock and paid in capital.
 - c. Adequate segregation of duties between maintaining owner's equity records and handling cash
 - d. Independent internal verification of information in the records

2. To determine whether owner's equity related transactions are recorded: Existing capital stock transactions are properly recorded.
3. To determine whether owner's equity balances are properly stated and disclosed

7.6 Audit Approach in Relation to Capital Stock and Paid In Capital

The following procedures are typical of the work required in many engagements for the verification of capital stock and paid in capital.

Obtain an understanding of internal control over capital stock and paid in capital.

Examine the articles of incorporation, by laws, and minutes for provisions relating to capital stock and paid in capital.

Obtain or prepare analyses of the capital stock accounts. Account for all proceeds from stock issues.

Confirm shares outstanding with the independent registrar and stock transfer agent.

Account for stock certificate numbers, examine cancelled certificates and reconcile the stockholder records with the general ledger.

Determine the compliance with stock option plans and with other restrictions and preferences pertaining to capital stock and paid in capital.

7.7. Audit of Dividends and Retained Earning

7.7.1. Audit Objectives of Dividends and Retained Earnings

The most important objectives in audit of dividends and retained earnings include determining whether:

Existing transactions are for dividends and retained earnings were fully

recorded Recorded dividends and retained earnings are authorized

Dividends paid to stockholders and retained earnings are properly

valued Dividend payables are properly valued and recorded

Retained earnings balance is properly disclosed in the balance sheet

7.7.2 Audit Approach in Relation to dividends and retained earning

Audit work on dividends and retained earnings includes the following two major procedures:

1. Analysis of retained earnings and any appropriations of retained earnings: Check whether the amounts debited and credited to retained earnings are appropriate. Credits to retained earnings represent amounts of net income transferred from income summary account. Debits to retained earnings account ordinarily include entries for net losses, cash and capital dividends, and for the creation or enlargement of appropriated reserves. Appropriations of retained earnings require specific authorization by board of directors.
2. Review of dividend procedures for both cash and stock dividends: In the verification of cash dividends, the auditors usually will perform the following:

√ Determine the dates and amounts of dividends authorized.

√ Verify the amounts paid.

√ Determine the amount of any preferred dividend in arrears.

√ Review the treatment of unclaimed dividend checks. Dividends declared but not paid must be shown as liabilities in the balance sheet.

7.8 Audit of Dividends objectives and verifications

The emphasis in the audit of dividends is on dividend transactions rather than on the ending balance. The exception is when there are dividends payable.

All six transaction-related audit objectives for transactions are relevant for dividends. But typically, dividends are audited on a 100 percent basis. The most important objectives, including those concerning dividends payable, are:

1. Recorded dividends occurred (**occurrence**).
2. Existing dividends are recorded (**completeness**).
3. Dividends are accurately recorded (**accuracy**).
4. Dividends are paid to stockholders that exist (**occurrence**).
5. Dividends payable are recorded (**completeness**).
6. Dividends payable are accurately recorded (**accuracy**).

Auditors can verify the occurrence of recorded dividends by examining the minutes of board of directors meetings for authorization of the amount of the dividend per share and the dividend

date. When doing so, the auditor should be alert to the possibility of unrecorded dividends declared, particularly shortly before the balance sheet date. A closely related audit procedure is to review the audit permanent file to determine whether restrictions exist on the payment of dividends in bond indenture agreements or preferred stock provisions.

The accuracy of a dividend declaration can be audited by recalculating the amount on the basis of the dividend per share times the number of shares outstanding. If the client uses a transfer agent to disburse dividends, the total can be traced to a cash disbursement entry to the agent and also confirmed.

When a client keeps its own dividend records and pays the dividends itself, the auditor can verify the total amount of the dividend by recalculation and reference to cash disbursed. In addition, auditors must verify whether the payment was made to the stockholders who owned the stock as of the dividend record date. They can test this by selecting a sample of recorded dividend payments and tracing the payee's name on the cancelled check to the dividend records. At the same time, auditors can verify the amount and the authenticity of the dividend check. Tests of dividends payable should be done in conjunction with declared dividends.

Any unpaid dividend should be included as a liability.

7.9. Audit of Retained Earnings

For most companies, the only transactions involving retained earnings are net earnings for the year and dividends declared. Other changes in retained earnings may include corrections of prior-period earnings, prior-period adjustments charged or credited directly to retained earnings, and the setting up or elimination of appropriations of retained earnings.

To begin the audit of retained earnings, auditors first analyze retained earnings for the entire year. The audit schedule showing the analysis, which is usually a part of the permanent file, includes a description of every transaction affecting the account.

To accomplish the audit of the credit to retained earnings for net income for the year (or the debit for a loss) auditors simply trace the entry in retained earnings to the net earnings figure on the income statement. This procedure must, of course, take place fairly late in the audit after all adjusting entries affecting net earnings have been completed. In auditing debits and credits to

retained earnings, other than net earnings and dividends, auditors must determine whether the transactions should have been included.

For example, prior-period adjustments can be included in retained earnings only if they satisfy the requirements of accounting standards. After the auditor is satisfied that the recorded transactions were correctly classified as retained earnings transactions, the next step is to decide whether they were accurately recorded. The audit evidence necessary to determine accuracy depends on the nature of the transactions. For example, if an appropriation of retained earnings is required for a bond sinking fund, auditors can determine the correct amount of the appropriation by examining the bond indenture agreement. If there is a major loss charged to retained earnings because of a material nonrecurring abandonment of a plant, the evidence needed to determine the amount of the loss can be complex and include examining a large number of documents and records, as well as discussions with management.

Auditors must also evaluate whether any transactions should have been included but were not. For example, if the client declared a stock dividend, the market value of the securities issued should be capitalized by a debit to retained earnings and a credit to capital stock. Similarly, if the financial statements include appropriations of retained earnings, the auditor should evaluate whether it is still necessary to have the appropriation as of the balance sheet date.

Accounting standards require presentation and disclosure of information related to retained earnings. The auditor's primary concern in determining whether presentation and disclosure objectives for retained earnings are satisfied primarily relates to disclosure of any restrictions on the payment of dividends. Often, agreements with bankers, stockholders, and other creditors prohibit or limit the amount of dividends the client can pay. These restrictions must be disclosed in the footnotes to the financial statements.

Summary

This chapter elaborates the equity audit procedures in partnership and corporation, internal control of equity audit, retained earnings audit and dividend audit.

Equity refers to the net worth of the business, i.e. the amount remaining after deducting total liabilities from total assets. Some of the internal controls for owners' equity activities are: Proper Authorization of Transactions; Proper Record Keeping and Segregation of Duties; Independent Registrar and Stock Transfer Agent. In audit of a corporation's equity there are own procedures presented in the main body of this chapter and partnerships also. Hence, the same principles described for the audit of corporate capital are applicable to the examination of the capital account and drawing accounts of sole proprietorship. The major audit procedures in auditing owners' equity of sole proprietorship or partnership are: Analyze all accounts from beginning of the business; Trace the initial capital investment and any addition to the cash and asset records and Verify the net income or loss for the period and any withdrawals are verified.

The most important objectives in audit of dividends and retained earnings include determining whether: Existing transactions are for dividends and retained earnings were fully recorded; Recorded dividends and retained earnings are authorized; Dividends paid to stockholders and retained earnings are properly valued; Dividend payables are properly valued and recorded and Retained earnings balance is properly disclosed in the balance sheet. And their own audit procedures discussed under this chapter.

Unlike other accounts, there is no need to develop detailed audit procedures for the audit of Net Asset/ Equity because; the balance is checked when checking the other accounts that give rise to that balance. The objectives of examining stocks include: Establishing credibility of the accounting records in respect of the stocks; Ascertaining the reasonableness of the stock account balances; Review of cut-off of recorded stock account transactions; Establishing the physical existence and the reasonableness of the stocks quantity figures determined by count; Determining the accuracy of the cost and of extension and footing of the stock valuations; and Determining that slow moving, damaged or obsolete items of stocks are segregated and reported.

SELF ASSESSEMENT QUESTIONS

Part I: True or False Questions

Write true if the statement is correct and false if the statement is incorrect.

1. A shareholders' capital stock master file is the record of the outstanding shares at any given time.
2. Auditors can verify the occurrence of recorded dividends by examining the minutes of board of directors meetings for authorization of the amount of the dividend per share and the dividend date.
3. To begin the audit of retained earnings, auditors first analyze retained earnings for the entire year.
4. The auditor's primary concern in determining whether presentation and disclosure objectives for retained earnings are satisfied primarily relates to disclosure of any restrictions on the payment of dividends.

Part II: Multiple Choice Questions

Choose the correct answer among the given alternatives.

1. Internal control is important for audit of equity to:
 - A. Proper Authorization of Transactions
 - B. Proper Record Keeping and Segregation of Duties
 - C. Independent Registrar and Stock Transfer Agent
 - D. All
2. Internal controls affecting dividend payments to:
 - A. Dividend checks are prepared from the capital stock certificate record by someone who is not responsible for maintaining the capital stock records.
 - B. After the checks are prepared, there is independent verification of the stockholders' names and the amounts of the checks and a reconciliation of the total amount of the dividend checks with the total dividends authorized in the minutes.
 - C. A separate impress dividend account is used to prevent the payment of a larger amount of dividends than was authorized.
 - D. All

E. B & C

3. The main concern of auditors in auditing capital stock and paid-in capital in excess of par are:
 - A. Existing capital stock transactions are recorded (completeness transaction-related objective).
 - B. Recorded capital stock transactions occurred and are accurately recorded (occurrence and accuracy transaction-related objectives).
 - C. Capital stock is accurately recorded (accuracy balance-related objectives).
 - D. Capital stock is properly presented and disclosed (all four presentation and disclosure objectives).
 - E. All.
4. Objectives of capital stock Audit are to examine:
 - A. Existing Capital Stock Transactions Are Recorded
 - B. Recorded Capital Stock Transactions Occurred and Are Accurately Recorded
 - C. Capital Stock Is Accurately Recorded
 - D. Capital Stock Is Properly Presented and Disclosed
 - E. All
5. To determine whether the internal control over owners' equity is adequate the auditors' verifying that:
 - A. Proper authorization of transactions – for issuance of stock, repurchasing of capital stock, and declaration of dividend.
 - B. Proper record keeping of capital stock and paid in capital.
 - C. Adequate segregation of duties between maintaining owner's equity records and handling cash
 - D. Independent internal verification of information in the records
 - E. All except B
 - F. All except E

6. Review of dividend procedures for both cash and stock dividends in the verification of cash dividends, the auditors usually will perform:
- A. Determine the dates and amounts of dividends authorized.
 - B. Verify the amounts paid.
 - C. Determine the amount of any preferred dividend in arrears.
 - D. Review the treatment of unclaimed dividend checks. Dividends declared but not paid must be shown as liabilities in the balance sheet.
 - E. None
7. An audit program for the audit of the retained earnings account should include a step that requires verification of:
- A. Market value used to charge retained earnings to account for a 2-for-1 stock split.
 - B. Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.
 - C. Authorization for both cash and stock dividends.
 - D. Gain or loss resulting from disposition of treasury shares.
8. Which of the following internal controls is least likely to reduce risks related to the occurrence transaction-related audit objective for issuances of stock?
- A. The board of directors must approve the distribution of cash dividends.
 - B. The issuance of any shares of stock must be pre-approved by the board of directors.
 - C. The company engages an independent registrar to issue stock certificates.
 - D. The company maintains a capital stock certificate record that includes certificate number, number of shares issued, issue date, and name of person to whom certificates are issued.
9. Which of the following audit procedures would be most relevant when examining the completeness transaction-related audit objective for capital stock?
- A. The auditor examines minutes of the board of directors' meetings to identify any actions involving the issuance of capital stock.
 - B. The auditor vouches entries in the client's capital stock records to board minutes.
 - C. Confirmations of new stock issuances are sent to the client's stock transfer agent.

D. The auditor traces entries of new stock issuances to the cash receipts journal.

Part III: Essay Type Questions (self-study)

Give short and clear answers for the following questions by your own self by referring the material you have.

1. Discuss the Audit Objectives and procedures of capital stock and paid in capital.
2. Describe the audit procedures in corporations and partnership.

Part IV: Case study questions (self-study)

After reading two wise and give appropriate answer for the following questions.

1. Items A through F are common questions found in internal control questionnaires used by auditors to obtain an understanding of internal control for owners' equity. In using the questionnaire for a client, a "yes" response indicates a possible internal control, whereas a "no" indicates a potential deficiency.
 - A. Does the company use the services of an independent registrar or transfer agent?
 - B. If an independent registrar and transfer agent are not used:
 - (a) Are unissued certificates properly controlled?
 - (b) Are cancelled certificates mutilated to prevent their reuse?
 - C. Are common stock master files and stock certificate books periodically reconciled with the general ledger by an independent person?
 - D. Is an independent transfer agent used for disbursing dividends? If not, is an impress dividend account maintained?
 - E. Are issues and retirements of stock authorized by the board of directors?
 - F. Are all entries in the owners' equity accounts authorized at the proper level in the organization?

Required:

- a. For each of the preceding questions, state the purpose of the control.
- b. For each of the preceding questions, identify the type of potential financial statement misstatements if the control is not in effect.
- c. For each of the potential misstatements in part b, list an audit procedure that the auditor can use to determine whether a material misstatement exists.

2. The following audit procedures are commonly performed by auditors in the verification of owners' equity:
 1. Review the articles of incorporation and bylaws for provisions about owners' equity.
 2. Analyze all owners' equity accounts for the year and document the nature of any recorded change in each account.
 3. Account for all certificate numbers in the capital stock book for all shares outstanding.
 4. Examine the stock certificate book for any stock that was cancelled.
 5. Review the minutes of the board of directors' meetings for the year for approvals related to owners' equity.
 6. Re-compute earnings per share.
 7. Review debt provisions and senior securities with respect to liquidation preferences, dividends in arrears, and restrictions on the payment of dividends or the issue of stock.

Required:

- a. State the purpose of each of these seven audit procedures.
- b. List the type of misstatements the auditors can uncover by the use of each audit procedure.
3. You are engaged in the audit of a corporation whose records have not previously been audited by you. The corporation has both an independent transfer agent and a registrar for its capital stock. The transfer agent maintains the record of stockholders and the registrar checks that there is no over issue of stock. Signatures of both are required to validate certificates. It has been proposed that confirmations be obtained from both the transfer agent and the registrar as to the stock outstanding at the balance sheet date. If such confirmations agree with the books, no additional work is to be performed as to capital stock.

Required:

If you agree that obtaining the confirmations as suggested will be sufficient in this case, give the justification for your position. If you do not agree, state specifically all additional steps you would take and explain your reasons for taking them.

ANSWER KEY FOR SELF-ASSESSMENT QUESTIONS

Chapter Two

1. B 2. C 3. D 4.E 5. D

Chapter Three

1. D 2. A 3. B 4. A 5. B

Chapter Four

1. A	6. D
2. B	7. A
3. D	8. C
4. A	9. D
5. E	10. A

1. True 2. True 3. True 4. True 5. False 6. True

Part II

1. E 2.D 3.D 4.B 5.C 6.B

Chapter Six

1. True 2. True 3. True 4. True

Part II

1. D 2.D 3.E 4.E 5.F 6.E 7.C 8.A 9.B Chapter Seven

1. True 2. True 3. True

Part II

1. B 2.E 3.D 4.D 5.D 6.E 7.E

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Any book on principles of auditing



**COLLEGE OF CONTINUING AND DISTANCE EDUCATION
DEPARTMENT OF ACCOUNTING AND FINANCE**

**MODULE FOR AUDITING
COURSE CODE ACFN 4161**

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PREFACE

Dear learners! By this module expected that learners are best served by acquiring a strong understanding of the basic concepts that underlie the audit process and how to apply those concepts to various audit and assurance services in Ethiopia. Moreover, this course (Audit and Assurance) explores the underlying theories, procedures and practices surrounding the auditor's responsibilities in undertaking an audit of financial statements of reporting entities. Auditing Princ. and Pract.s a two-semester course decomposed as part I and part II. This module discusses all about the concepts of part I. However, the second part moreover focused on the practical part of auditing and assurance service.

Exclusively, this module deals with concepts and principles of auditing, include auditing profession, the process of collecting and evaluating evidence to determine whether an economic entity safeguards asset, maintains data integrity, and produces reliable financial statements. It also covers the study and evaluation of internal control and the role of internal auditors in fraud prevention and detection. Audit reports on financial statements and the most frequent variations in audit are also covered.

At the end of the course, learners will be able to:

- Understand the nature, purpose, scope and types of audit and assurance services
- Be acquainted with the underlying professional standards that Public Accounting employs and the primary legal concepts and terms therein.
- Comprehend the significance of internal control assessment in the planning and conducting of an audit.
- Distinguish the different types of Audit Reports and the variety of circumstances and conditions where one is more appropriate than the others.
- Be familiar with the working of the auditing profession in international standards and in Ethiopia.

Thus, I believe that this module contributes a lot to achieve above mentioned learning objectives of the course since it is compiled from various revised and updated books and reference materials Auditing. Most importantly, we highly appreciate in advance learners and other stakeholder's constructive comments and suggestions, since they will have paramount importance to us to prepare the revised version of the material in the near future.

You can send your constructive comments and suggestions through mesheshatinishu@yahoo.com and retamekdelawit7@gmail.com

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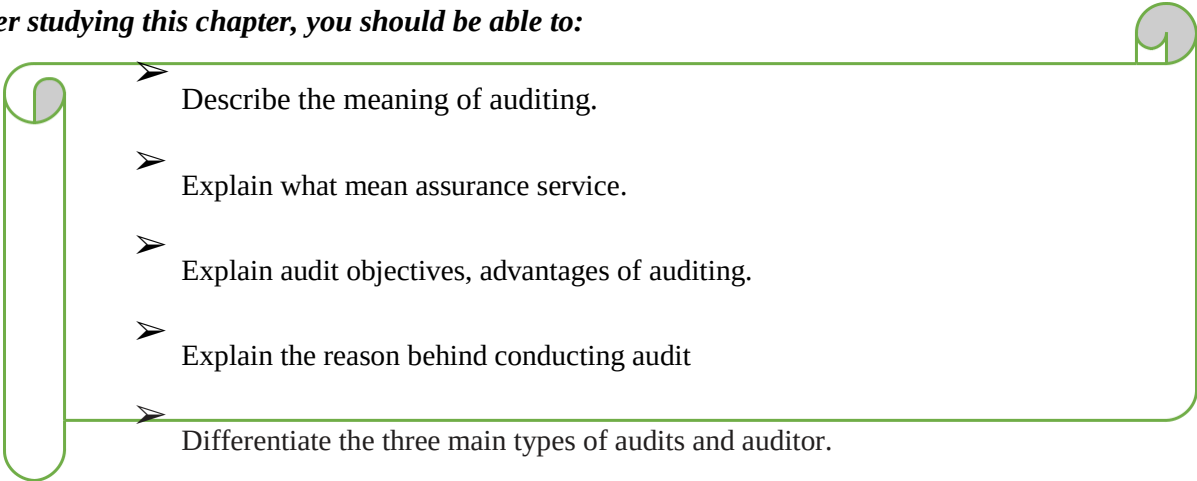
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CHAPTER ONE

THE NATURE, PURPOSE, SCOPE OF AUDIT AND ASSURANCE SERVICES

1.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 
- Describe the meaning of auditing.
 - Explain what mean assurance service.
 - Explain audit objectives, advantages of auditing.
 - Explain the reason behind conducting audit
 - Differentiate the three main types of audits and auditor.

1.1. INTRODUCTION



Dear learners! In this chapter you will learn about the overview of auditing. Auditing Princ. and Pract.s an independent examination. The word “audit” comes from the Latin word *audire* which means “to hear.” In the middle Ages, accounts or revenue and expenditure were “heard” by the auditor. As you know Reliable information is necessary in order to help manager, investor, creditors and regulatory agencies to make informed and wise decision. Auditing play an important role in this aspect by providing objectively determined and independent reports on the reliable of financial information. Auditing Princ. and Pract.s important to both private and public enterprises. By adding the audit function to each situation, the users of financial statement will have **reasonable assurance** that the financial statements do not contain material misstatement or omission.

1.1 Meaning of Audit

Definition of Auditing Over the years, a variety of organizations and individuals have defined the broad form "auditing". For example, the American Accounting Associations Committee on Basic Auditing concepts developed a definition of auditing as follows:

Auditing Princ. and Pract.s 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 results to interested users. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding.

Information and established Criteria

To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information. This information can take many forms.

- ✓ Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns.
- ✓ Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Apple's financial statements, the CPA firm will determine whether Apple's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO). For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Apple's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the

effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

Accumulating and evaluating evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria.

Evidence takes many different forms, including:

- Electronic and documentary data about transactions
- Written and electronic communication with outsiders
- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and quantity of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit.

Competent, Independent person

The auditor must be qualified to understand the criteria used and must be competent to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an independent mental attitude. The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

Independence can be defined as consisting of two components:

1. **Independence in mind:** reflects the auditor state of mind that permits the auditor to be performed with an unbiased altitude. This Independence of mind also reflect a long-standing requirement that the auditors be independent in fact.
2. **Independence in appearance:** is the result of others interruption of this independence, if auditors are independent in fact but users believe them to be advocates for the clients. In this kind of case most of the value of the audit function is lost. Thus, auditors must be independent not only in fact (mind) but also in appearance to maintain public confidence.

Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called independent auditors. Even though such auditors are paid fees by the company, they are normally sufficiently independent to

conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

As the definition implies, auditing encompasses both an investigative process and a reporting process. In the audit of an entity's financial statements called a financial statement audit investigation involves a systematic gathering and evaluation of evidence as a basis for reaching an opinion about whether assertions made by management in an entity's financial statements correspond in all material respects with generally accepted accounting principles (GAAP). For example, management asserts whether all existing inventories represent properties or rights of the entity, reflect all related transactions for the period, are valued at appropriate amounts, and are presented properly in the financial statements.

Management makes similar assertions for each account in the financial statements; in a financial statement audit, the independent auditor investigates evidence about whether these assertions are appropriate. In turn, reporting means communicating an opinion in a written report to interested users of the financial statements. The opinion an auditor conveys in all audit report depends on the information content of evidence gathered during the audit and may indicate either that the financial statements are presented fairly in conformity with GAAP or that the statements are not presented fairly.

The International Federation of Accountants (IFAC) defines an audit as: An audit is a work performed by an auditor to enable him/her to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

Reporting

The final stage in the auditing process is preparing the audit report, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

As the above definition shows an audit does not certify or guarantee that the financial statements are correct or not; it only gives a reasonable assurance that the financial statements are free from material misstatements. An audit may fail to detect over material misstatements because of the following reasons.

- i) An audit is based on a sample. Therefore, the evidence collected is persuasive rather than conclusive.
- ii) ii) Internal control systems that auditors rely on to perform their work have their own limitations.

Below, there are some additional definitions given to an audit by different scholars and institutions.

According to Montgomery, a prominent American Accountant “Auditing Princ. and Pract.s a systematic examination of the books and records of a business or other organization, in order to ascertain or verify, and to report upon the facts regarding its financial operation and the results thereof”.

According to Ronald Irish states “Auditing Princ. and Pract.n its modern concept, is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the balance sheet and the net income revealed by the income statement”

According to L.R. Dicksee “An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate.

In some instances, it may be necessary to ascertain whether the transactions themselves are supported by proper authority”. International Auditing Guidelines of the International Federation of Accountants describes an audit as “The independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon”.

1.2 Assurance Services: Overview

Assurance services involve lending credibility to information, whether financial or nonfinancial. It is an independent professional service that improves the quality of information for decision makers. Such services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions.

CPAs have provided many assurance services for years, particularly assurances about historical financial statement information. CPA firms have also performed assurance services related to lotteries and contests to provide assurance that winners were determined in an unbiased fashion in accordance with contest rules. More recently, CPAs have expanded the types of assurance services they perform to include forward-looking and other types of information, such as company financial forecasts and Web site controls. For example, businesses and consumers using the Internet to conduct business need independent assurances about the reliability and security of electronic information.

The demand for assurance services continues to grow as the demand increases for real-time electronic information. One category of assurance services provided by CPAs is attestation services. An attestation service is a type of assurance service in which the CPA firm issues a report about the reliability of an assertion that is made by another party. Attestation services fall into five categories:

1. **Audit of Historical Financial Statements:** In an audit of historical financial statements, management asserts that the statements are fairly stated in accordance with applicable U.S. or international accounting standards. An audit of these statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the applicable accounting standards. These audits are the most common assurance service provided by CPA firms.
2. **Audit of Internal Control over Financial Reporting:** For an audit of internal control over financial reporting, management asserts that internal controls have been developed and implemented following well established criteria. Section 404 of the Sarbanes–Oxley Act requires public companies to report management’s assessment of the effectiveness of internal control. The Act also requires auditors to attest to the effectiveness of internal control over financial reporting. This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting, because effective internal controls reduce the likelihood of future misstatements in the financial statements.
3. **Review of Historical Financial Statements:** For a review of historical financial statements, management asserts that the statements are fairly stated in accordance with accounting standards, the same as for audits. The CPA provides a lower level of assurance for reviews of financial statements compared to a high level for audits, therefore less evidence is needed. A review is often adequate to meet financial statement users’ needs. It can be provided by the CPA firm at a much lower fee than an audit because less evidence is needed. Many nonpublic

companies use this attestation option to provide limited assurance on their financial statements without incurring the cost of an audit.

4. **Attestation Services on Information Technology:** For attestations on information technology, management makes various assertions about the reliability and security of electronic information. Many business functions, such as ordering and making payments, are conducted over the Internet or directly between computers using electronic data interchange (EDI). As transactions and information are shared online and in real time, businesspeople demand even greater assurances about information, transactions, and the security protecting them.
5. **Other Attestation Services:** CPAs provide numerous other attestation services. Many of these services are natural extensions of the audit of historical financial statements, as users seek independent assurances about other types of information. In each case, the organization being audited must provide an assertion before the CPA can provide the attestation. For example, when a bank loans money to a company, the loan agreement may require the company to engage a CPA to provide assurance about the company's compliance with the financial provisions of the loan. The company requesting the loan must assert the loan provisions to be attested to before the CPA can accumulate the evidence needed to issue the attestation report

Activity



Dear learner! Based on the above discussions the five categories of attestation services

ASPECTS TO BE COVERED IN AUDIT

As you may understand from the definitions of an audit given above there are different aspects to be covered in audit activities. The principal aspects to be covered in an audit are the following:

1. An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in

actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

2. Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to all frauds and errors going unnoticed.
3. Checking of the arithmetical accuracy of the books of account by the verification of postings, balances etc.,
4. Verification of the authenticity and validity of transaction entered into making an examination of the entries in the books of accounts with the relevant supporting documents.
5. Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts correspond to the accounting period.
6. Comparison of the balance sheet and income statement or other statements with the underlying record in order to see that they are in accordance with the records kept.
7. Verification of the title, existence and value of the assets and liabilities appearing in balance sheet.
8. Checking the result shown by the income (profit) and to see whether the results shown are true and fair.
9. Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
10. Reporting to the appropriate person/body the statements of accounts examined reveal a true and fair presentation of the state of affairs and income of the organization

Activity



Dear learner! Based on the above discussions (definitions of an audit and aspects to be covered in audit) try to mention the reasons why an audit is considered to be necessary?

1.3 WHY AUDITS ARE CONDUCTED

Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different points of time with numerous person and entities. The effects of all transaction have to be recorded and suitably analyzed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transaction.

Because of all the reasons like accidental errors, lack of knowledge of accounting principles, unintentional bias, and deliberate falsification, financial statements may depart from generally accepted accounting principles. Audit of financial statements and other accounts books provide users (Management, Investors, Creditors, Bankers, Governmental Agencies, Financial Analysts, Stock Exchanges or Markets, Stockholders, Bondholders and other Economy Exchanges) with assurance that financial statements do not materially depart from generally accepted accounting principles (GAAP).

An important question a student might ask is " what is the purpose of audit service?" Some of the reasons for request are related to the issues discussed in the two paragraphs here above. Among the other reasons the majors are the following:

A. Control Mechanism

Audits whether internally or externally performed are valued as important control mechanisms for accountability. The overall need for monitoring activities, especially financial activity includes the need for auditing to provide credibility for reported and unreported information. Those who have invested their money in the business but cannot take part in its management, for example shareholders in a company, certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic.

In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, creditors, and other participants like Banks, Governmental Agencies, Financial Analysts and Stock exchange.

B. To Manage Conflict of Interest

The agency relationship that exists between an owner and manager produces a natural conflict of interest because of the information asymmetry that exists between the manager and the absentee owner. Information asymmetry means that the manager generally has more information about the "true" financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximize their own self-interest, it is likely that the manager will not act in the best interest of the owner.

Whenever there is a conflict of interest between parties, the need for an arbiter or a non-partisan view is obvious. In financial affairs there are natural grounds for conflict of interest between information preparer and user, which can result in the production of a biased information data. Thus, an audit is required for an objective review of the information.

C. To Reduce Damaging Consequence

The ultimate objective and function of accounting is to provide information for economic decision-making. Financial statements are often the basis for decisions making by the management and for corrective action as to even closing down the organization or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned an income, but because of wrong accounting the annual accounts show a loss, the proprietor may take the decisions to sell the business at a loss. Thus, there is a purpose for an audit for verifying the accuracy of information before they are used in decisions that may bring damaging consequences.

D. Facilitate the Remoteness of Information

Because of the owners' being separate from the management of a business; information is prepared in a place far from the user. The owners' will be prevented from directly assessing the quality of information they obtain. Thus, they need for auditors' service to assess the information on behalf of them.

E. Regulatory Requirements

Many business laws, memorandum of association and regulatory agencies acts make audits annual requirements to be complied with for renewal of license or permit. For example, the security exchange commission (SEC) in the United States of America; the Commercial Code of Ethiopia (1966), and later

the Public Financial Regulation of Proclamation 163/1999 in Ethiopia make the filing of audited financial statements annually. Disaster Prevention and Preparedness Commission (DPPC) requires NGOs to prepare and submit their annual financial statements. Thus, compliance requirements create a very large demand for auditing services.

1.3.1 OBJECTIVES AND ADVANTAGES OF AUDITING

Objectives of Auditing

Under this sub-topic the objectives of an audit will be discussed in two parts i.e. as a primary objectives and secondary objectives as presented below. The principal objective of an audit is to enable the auditor to gather and evaluate *audit evidence* of sufficient quantity and appropriate quality in order to form, and communicate to the users of the financial statements an audit opinion on the truth and fairness of the financial position and operating results as shown by an organization. The management of the organization or the concern submits the financial statements to the auditor who then verifies that the accounts are prepared within the framework of recognized accounting policies and practices and relevant statutory requirement, if any. Based on his checking the auditor expresses his opinion about the quality of the financial statements concerning proper disclosure of facts and the truth and fairness of the financial position and results of operation of the enterprise.

The secondary objectives of an audit are generally taken to be as follows: -

A. Detection and prevention of errors

B. Detection and prevention of frauds

A. Detection and prevention of errors: Errors are unintentional (made unknowingly) acts of misstatements which can be classified into:

1. Errors of Omission: An error of omission arises from omitting to record a transaction fully or partially in the book of accounts. Such errors do not affect the equality of the trial balance. The examples of such errors are omission of recording purchase, sale, adjusting entry etc or not posting entry passed in journal to a ledger.

2. Errors of Commissions: An error of commission arises as a result of recording a transaction incorrectly, either partially or wholly. Such errors do not affect the equality of the trial balance but if posted wrongly in both sides of the trial balance they may affect. Examples may include recording Birr

5000 bill purchase as Birr 500 or wrongly posting an amount correctly recorded in a journal as Birr 4500 as Birr 3500.

3. Errors of Principle: An error of principle arises from the failure to observe fundamental principles of accounting in recording the transactions. These errors do not affect the equality of the two sides of a trial balance. Incorrect allocation of expenditure between capital and revenue, incorrect bases of valuation of current assets and fixed assets, incorrect adjustment of prepaid expenses and accrued income, incorrect provisions for depreciation, etc., are some examples of errors of principle.

4. Errors of Duplication: Errors of duplication arises from recording a transaction twice and posting the same twice to the ledger, and have no impact on the equality of the trial balance.

5. Error of Compensating: A compensating error arises from an error being offset by another error or errors. Such errors also do not affect the arithmetical accuracy of the trial balance. Debiting cash for Birr 30,000 instead of crediting the same and crediting account payable for Birr 30,000 instead of debiting can be considered as an example of compensating error.

B. Detection and prevention of frauds: A fraud is intentionally made act of misstatement involving either misappropriation of cash, goods or any property; or falsification (manipulation) of accounts. Misappropriation (embezzlement) of cash is very easy and can be committed by not entering a receipt, or by entering receipt of lesser amount, or by showing fictitious payments. The chances of misappropriation of goods are also more in case of business organizations where the goods are of less volume but of high value. Manipulation of accounts can be made with the objective of reducing profit or inflating profit by using some devices like non provision of depreciation, wrong classification of expenditures, under/over valuation of assets and non-provision of bad debt expenses.

Advantages of Auditing

The following are the major advantages of an audit:

1. Detection and prevention of errors and frauds. As it was mentioned above an audit can help in detecting and preventing errors and frauds.
2. The account books are kept and maintained with accuracy and up to date because they are subjected to audit.

3. The organizations can get the benefits of the suggestions of the auditor and thus improve the working of their accounts section. The auditors will recommend on issues which need improvement after completing the audit.
4. In the case of large organizations, the interests of many parties are protected. The shareholders, government tax institutions and other stakeholders will have confidence on the financial statements of the audited business since an independent body proved it.
5. The valuation of assets and liabilities becomes easy in case the whole business of the organization is to be sold since the assets and liabilities are periodically audited.
6. Audited accounts will be more acceptable to banks and other financial institutions in obtaining funds and extending financial accommodation. The financial institutions will not provide fund (will not lend) unless the borrower provide audited financial statements.
7. Audited accounts will carry greater authority for tax assessment by tax authorities.
8. In the case of partnership organizations audited accounts will help in avoiding disputes between the partners especially where profit sharing arrangements are complex. So also, the admission of a new partner or the death, retirement, etc., of an existing partner or the sale of the business as a going concern may require revaluation of assets and liabilities and the computation of goodwill. In such cases, audited accounts will be more suitable bases.

Activity



Dear learner! Based on discussions made above please try to guess
s advantages of an audit?

1.4 TYPES OF AUDITS AND AUDITORS

Types of Audits

While there are many types of audits based on the definitions previously provided, generally they are often viewed as falling into three major categories:

1. Audits of Financial Statements
2. Compliance Audits
3. Operational Audits

1. Audits of Financial Statements

Audit of financial statements covers the balance and related statements of income, retained earnings, and cash flows. The goal is to determine whether these statements have been prepared in conformity with specified criteria and to provide assurance for third parties or external users that such statements present a company's financial condition and results of operations 'fairly'. Users of auditors' reports include management, investors, bankers, creditors, financial analysts, government agencies and other interested parties.

Normally, the criteria to which these statements adhere are generally accepted accounting principles (GAAP) and generally accepted standards set by governing bodies regulating businesses. Financial statement audits are normally performed by firms of certified public accountants.

2. Compliance Audits

In our society the largest organization of all is the Government. Government is truly big business, and there are a countless of agencies both responsible for administration of complex regulations and which themselves are subject to such regulations. Compliance audit is concerned with examining whether government resources are used properly and in compliance with related government rules and regulations.

The purpose of compliance audit is dependent upon the existence of verifiable data and of recognized criteria or standards, such as established laws and regulations, and or an organization's policies and procedures. For example, the audit of income tax returns by an auditor of the Inland Revenue service may seek to determine whether a tax return is in compliance with tax laws and Inland Revenue regulations.

Like an independent financial statement audits, a compliance audit is designed to determine whether an entity's financial statements are presented fairly in accordance with generally accepted accounting principles. However, unlike a financial statement audit, a compliance audit is also designed to determine whether the entity has complied with applicable laws and regulations – hence the term "compliance" audits – that may have a material effect on financial statements. Compliance audits are conducted by either independent auditors or government auditors.

As with internal auditing, the compliance audit is an appraisal activity which measures the extent to which organizational objectives are met. The reports of compliance audit highlight inefficiencies and make recommendations for improving the efficiencies and effectiveness of operations.

3. Operational Audits

An operational audit is a systematic independent appraisal activity of a specific unit of an organization for the purpose of measuring its performance. Operational audit is concerned with the operating propriety and efficiency of the functional areas of an organization. Its primary objective is to assess the quality of operations and whether it is in line with the company's prescribed policies/plans. The operations of the receiving department of a manufacturing company, for example, may be evaluated in terms of its effectiveness, that is, its success in meeting its stated goals and responsibilities. Performance is also judged in terms of efficiency, that is, success in using resources to the best advantage available to the department or the organization.

The purpose of an operational audit is to assess performance, identify areas of improvement, and develop recommendations. Sometimes this type of audit is referred to as a performance audit or management audit. Because the criteria for effectiveness and efficiency are not as clearly established as are generally accepted accounting principles and many laws and regulations, an operational audit tends to require more subjective judgment than do audits of financial statements or compliance audits. For example, quantifiable criteria often must be developed by the auditors to be used to measure the effectiveness and efficiency of the department.

Activity



Dear learners! Try to answer the questions below and check your progress
Write the types of audits and explain them.

Types of Auditors

Above, we have seen the different types of audits; likewise, there are different types of auditors classified based their different characteristics. There are a number of different types of auditors, however, they can be classified under the major three headings: - Internal auditors, external auditors and government auditors. The types of auditors are discussed below in detail as follows;

A. Internal Auditors

Nearly every large organization maintains an internal auditing staff. Internal auditors are also employed extensively by governmental and nonprofit organizations. A principal goal of the internal auditors is to investigate and evaluate the effectiveness with which the various organizational units of the company are carrying out their assigned functions. Internal Auditing Princ. and Pract.s essentially an appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. By measuring and evaluating the effectiveness of organizational controls, internal auditing, itself is an important managerial control device. The principal products of internal audit are recommendations for improving the efficiency and effectiveness of operations and the influence exerted on people whose activities and subject to audit.

The Institute of Internal Auditors (IIA) of US has developed a set of standards that should be followed by internal auditors and has established a certification program. An individual meeting the certification requirements set by the IIA, which includes passing a uniform written examination, can become a certified internal auditor (CIA).

Like external auditors (discussed below), internal auditors must be objective and independent. To help ensure the objectivity and independence of internal auditors, the IIA suggests that the director of internal auditing report directly to either the board of directors or the audit committee of the board or have free access to the board. Regardless of their reporting level, however, internal auditors are not independent in the same sense as external (independent) auditors. The internal auditors are employees of the company in which they work, subject to the restraints inherent in the employer – employee relationship.

Internal auditors can be involved in all three types of audits. Their primary activities are to conduct compliance and operational audits within their organization. They also engage in testing whether the firm is undertaking its activities and using its resources efficiently and effectively to achieve its

objectives. However, they may also assist the external auditors with the annual financial statement audit.

Unlike the external auditors, who are committed to verify cash significant item in the annual financial statements, the internal auditors are not obliged to repeat their audits on an annual basis. While external auditor (CPA) concentrates on an overall evaluation of financial statements submitted to the third parties, the internal auditor is more concerned with the effectiveness of detailed operating reports to management.

B. External Auditors

External auditors are often referred to as independent auditors or certified public accountants. Such auditors are called "external" because they are not employed by the organization being audited. It might even be said that their basic task is to confirm to the owners that the employees are correctly reporting on their own financial performance. The independent auditor is paid a fee by the auditee, and is responsible primarily to third parties (users of financial statements such as: investors, bankers, government, financial analysts, stock exchanges and other agencies). An external auditor conducts financial statement audits for publicly traded and private companies, partnerships, municipalities, individuals and other types of entities. They may also conduct compliance and operational audits for such entities. An external auditor may practice as a sole proprietor or as a member of a CPA firm.

The CPA certificate is regulated by state law through licensing department in each country. The requirements for becoming a certified public accountant vary among countries. In our country the General Auditors grants the license to work as an independent auditor when someone has the certificate of certified public accountant through passing the qualification exams given in US (CPA) or UK (ACCA). In addition to these qualification exams the individual should possess at least three-year experience in audit.

Professional standards require that external auditors should maintain their objectivity and independence when providing auditing or other attestation services for clients. Later in the text, independence and objectivity will be discussed in depth.

C. Government Auditors

The concept, content and scope of government audit develop in tune with the political, social and economic development of the country. Government audit aims to ensure accountability of the executive

in respect of public revenue and expenditure. The objective of Government Auditing Princ. and Pract.s that of systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

In order to achieve their objectives governments have established their own auditors called government auditors having their own independent offices. For instance, the federal government auditors of United States of America are called General Accounting Office (GAO) auditors. The work of GAO auditors includes compliance, operational and financial audits. These assignments include audits of government agencies to determine that spending programs follow the intent of the congress and operational audits to evaluate the effectiveness and efficiency of selected government programs. GAO auditors conduct examinations of corporations holding government contracts to verify that contract payments by the government have been proper. In addition, the financial statements of a number of federal agencies and the consolidated financial statements of the federal government are audited by the GAO. GAO is responsible to the legislature, or executive, but ultimately to the taxpayers. All Compliance Audits are performed by GAO auditors.

The Government of Ethiopia has an auditor general and the various regional governments are expected to have Auditor Generals who are responsible for auditing the agencies who report to that government. Federal Government agencies and departments are audited by the Office of the Federal Auditor General (OFAG). The extent and scope of the audits performed are determined by legislation in the various jurisdictions. Up to 1994 OFAG was the only government audit institution in Ethiopia. Proclamation No. 68/1997 gave the Office of the Federal Auditor General (OFAG) the power and duty to undertake financial and performance audits (or cause to be audited) on accounts of the federal government offices and organizations, accounts involving budgetary subsidies and special grants extended by the federal government to Regional States.

Activity: Dear learner! What are the key points which differentiate an internal auditor from that of the external auditor? And what make governmental auditor different? Please try to list down

CHAPTER SUMMARY

This chapter discussed about the general overview of auditing. Auditing the independent examination of and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation. Since audits involve examinations of financial information by independent experts, they increase credibility of the information contained in the statements. The nature and emphasis of auditing has changed over the years. Auditing began with the objective of detecting fraud by examination of all, or most, business transactions. Today the objective of an audit is to attest to the fairness of the financial statements. Audits can be generally classified in to Financial Statements audits, compliance audits, internal audits, operational audits and comprehensive audits. The auditing profession is much broader than auditors involved in public accounting (external auditors), it also includes internal auditors and various governmental auditors.

SELF TEST QUESTIONS

PART I- TRUE OR FALSE QUESTIONS

Say 'true' if the statement is correct and 'false' if it is wrong!

1. An audit does certify that the financial statements are correct or not.
2. Errors of commission arise from recording a transaction twice and posting the same twice to the ledger.
3. A company is either audited by the GAO or internal auditors, but not both.
4. Like a financial statement audit, a compliance audit is designed to determine whether the entity has complied with applicable laws and regulations.
5. A principal objective of the internal auditors is to investigate and evaluate the effectiveness of the various units of the company are carrying out their functions.

PART II: FILL THE BLANK SPACE QUESTIONS

Fill the blank space using the correct word!

1. _____ is a systematic examination of the books and records of a business or other organization, in order to ascertain or verify, and to report upon the facts regarding its financial operation and the results thereof.
2. A _____ error arises from an error being offset by another error or errors.
3. The purpose of _____ is to assess performance, identify areas of improvement, and develop recommendations.
4. _____ Certified public accountants or accounting firms that perform audits of commercial and non-commercial financial entities
5. _____ auditors employed by a company to audit for the company's board of directors and management.

PART III. SHORT ANSWER QUESTIONS

Give brief and neat answers for the following questions (give further explanation if needed)

1. Define auditing and its phrases?

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2. What is mean by reasonable assurance?

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3. Discuss the types of audit?

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4. What are the major differences and similarities between governmental and external auditors?

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CHAPTER TWO

The Auditing Profession

2.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- ❖ Discuss the Regulatory Framework Governing Auditing.
- ❖ Explain the role of international auditing standards.
- ❖ Use auditing standards as a basis for further study.
- ❖ Explain the Professional Ethics
- ❖ Understand Rights and Duties of an Auditor

2.1. INTRODUCTION



Dear learners! Here in this chapter you will learn about Auditing standards and techniques. You may recall from what you have learnt in your other accounting courses and discussions made that the guiding principles for accountants are called the Generally Accepted Accounting Principles (GAAP). Like accountants, Auditors are also expected to check whether the client prepared the financial statements based on this principle (GAAP) and ruled by different standards and guidelines. In this chapter we, will see together, the auditing standards that guidelines to aid auditors in fulfilling their professional responsibilities in the audit of historical financial statements. They include consideration of professional qualities such as competence and independence, reporting, requirements, and evidence. The three main sets of auditing standards are International Standards on Auditing, U.S. Generally Accepted Auditing Standards for entities other than public companies, and PCAOB (Public Company Accounting Oversight Board) Auditing Standards.

2.2 The Regulatory Framework Governing Auditing

The regulatory framework provides increasing focus of attention on the duties both of Internal Auditors and External Auditors. This is in consistency with requirements of Corporate Governance. Auditors are given certain rights under the Companies Acts to ensure that

- ❖ they fulfill their duties and responsibilities
- ❖ they maintain independence.

Statutory framework of Auditor's is important for all auditors:

To be aware of the regulatory framework for auditing. And to keep up to date with any changes that occur. Changes in regulations could affect by the audit role and demand of their services and How audit is performed and the amount of work, there is a trend toward globalization within companies and there is similar trend in auditing. This means that auditors need to be aware not only of Tanzanian regulations but also of those other countries covered by audit.

There is a greater focus on ISAs, that has led to Change of approach and Gave more clearly defined roles and rules for auditors. There are different types of regulatory impact affecting the operation of company and auditing: But our focus is on:

- The Companies Act 2002,
- Public Sector requirements (e.g. Public Finance Act 2001). Auditing regulations by companies act 2002

Function of the companies Act.

Most audit work involves companies incorporated under Companies Act 2002 which sets out:-

The requirements for audit Rules on appointment, removal, resignation and retirement of auditors. Auditors' rights, duties and qualifications.

Audit requirements.

- ❖ Not all companies are required to have their accounts audited,
- ❖ Many exemptions apply to small and medium sized companies,
- ❖ Generally, small private companies are totally exempt from audit requirements,



Medium-sized companies may file their accounts with the registrar of companies

2.3 International Standards on Auditing (ISA)

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). IFAC is the worldwide organization for the accountancy profession, with 159 member organizations in 124 countries, representing more than 2.5 million accountants throughout the world.

The IAASB works to improve the uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and attest functions and by promoting their acceptance worldwide.

ISAs do not override a country's regulations governing the audit of financial or other information, as each country's own regulations generally govern audit practices. These regulations may be either government statutes or statements issued by regulatory or professional bodies, such as the Australian Auditing & Assurance Standards Board or Spain's Instituto de Contabilidad Auditoria de Cuentas. Most countries, including the United States, base their auditing standards on ISAs, modified as appropriate for each country's regulatory environment and statutory requirements.

The Auditing Standards Board in the U.S. has revised most of its standards to converge with the international standards. In addition, the PCAOB considers existing international standards in developing its standards. As a result, U.S. standards are mostly consistent with international standards, except for certain requirements that reflect unique characteristics of the U.S. environment, such as legal and regulatory requirements.

Public Company Accounting Oversight Board Auditing Standards

The PCAOB initially adopted existing auditing standards established by the ASB as interim audit standards. In addition, the PCAOB considers international auditing standards when developing new standards. As a result, auditing standards for U.S. public and private companies are mostly similar. Standards issued by the PCAOB are referred to as PCAOB Auditing Standards in the audit reports of public companies and when referenced in the text, and apply only to the audits of public companies.

International auditing standards as adopted by standard-setting bodies in individual countries apply to audits of entities outside the United States. Generally accepted auditing standards are similar to international auditing standards and apply to the audits of private companies and other entities in the

United States. PCAOB auditing standards apply to audits of U.S public companies and other SEC registrants.

U. S Generally Accepted Auditing Standards

Like accountant must follow the guideline principle GAAP or IFRS in preparation of financial statement, auditor must follow the professional standards **entitled General accepted auditing standards (GAAS)** to determine whether these financial statements are prepared and presented in accordance with GAAP or IFRS, or some other specified criteria.

Auditing standards for private companies and other entities in the United States are established by the Auditing Standards Board (ASB) of the AICPA. These standards are referred to as Statements on Auditing Standards (SASs). These Generally Accepted Auditing Standards (GAAS) are similar to the ISAs, although there are some differences.

If an auditor in the United States is auditing historical financial statements in accordance with ISAs, the auditor must meet any ISA requirements that extend beyond GAAS. Prior to passage of the Sarbanes–Oxley Act, the ASB established auditing standards for private and public companies. The PCAOB now has responsibility for auditing standards for public companies, while the ASB continues to provide auditing standards for private companies and other entities.

The American institution of certified public accountant (AICPA) is the largest professional association for CPAs in the United States. CPAs are licensed by the state in which they practice, but a significant influence on CPAs is exerted by their national professional organization (AICPA). Membership in the AICPA is restricted to CPAs, but not all members and other practicing CPAs must follow. Auditing standards applicable to all private companies' audit and other entities in United States are established by the Auditing Standard Board ASB of the AICPA.

The broadest guidelines available to auditors in the U.S. are the 10 generally accepted auditing standards (GAAS), which were developed by the AICPA.

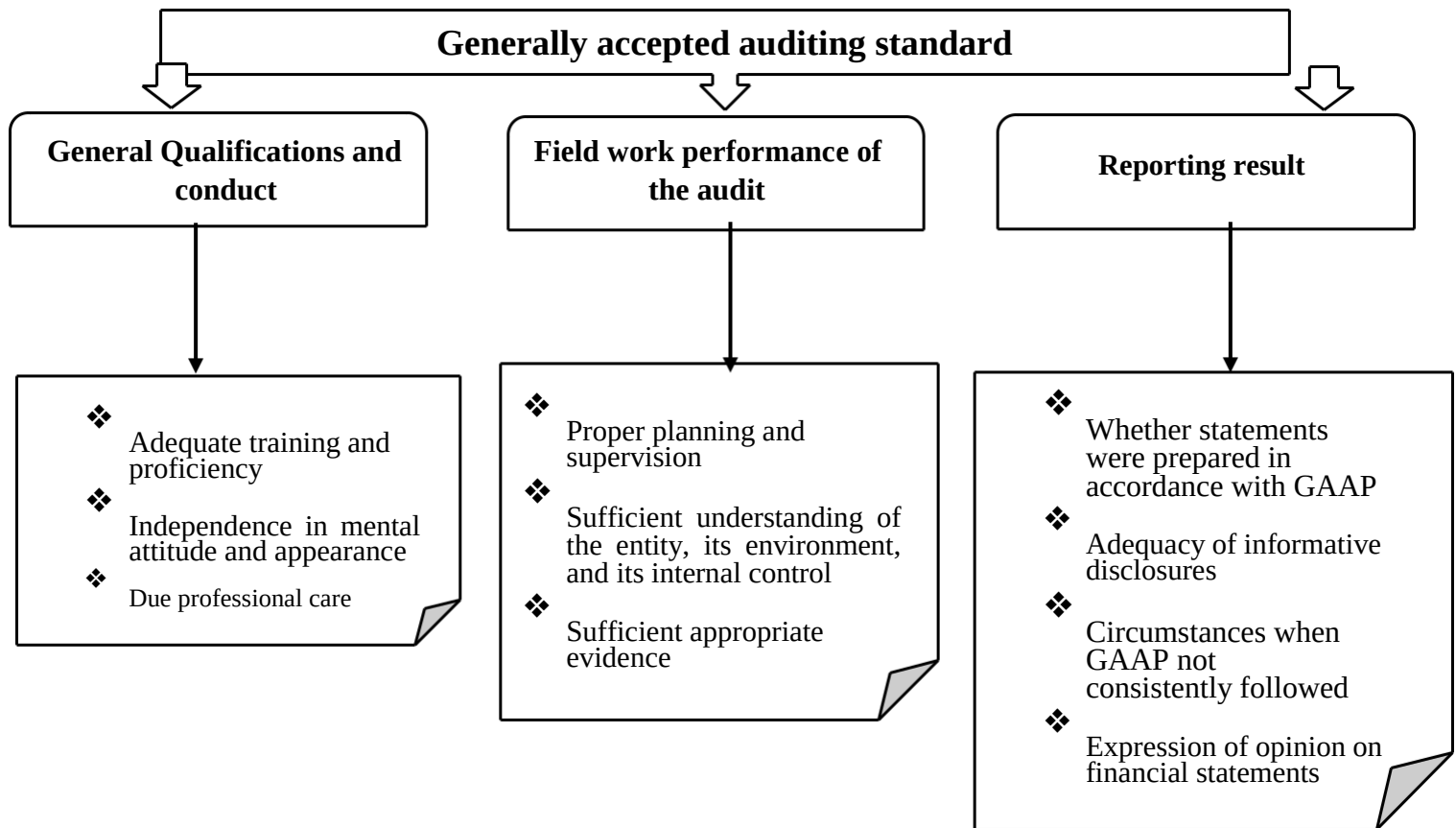


Figure 1 GAAS principles

As illustrated in Figure 1, the 10 generally accepted auditing standards fall into three categories:

- ❖ General standards
- ❖ Standards of field work
- ❖ Reporting standards

These standards are not sufficiently specific to provide any meaningful guide to practitioners, but they do represent a framework upon which the AICPA can provide interpretations.

A. General Standards

The general standard stress the important personal qualities that the auditor should possess, these include; adequate technical training and proficiency, independence and due professional care.

Adequate Technical Training and Proficiency: The first general standard is normally interpreted as requiring the auditor to have formal education in auditing and accounting, adequate practical experience for the work being performed, and continuing professional education. Recent court cases clearly demonstrate that auditors must be technically qualified and experienced in those industries in which their audit clients are engaged. In any case in which the CPA or the CPA's assistants are not qualified to perform the work, a professional obligation exists to acquire the requisite knowledge and skills, suggest someone else who is qualified to perform the work, or decline the engagement.

Independence in Mental Attitude: according to this standard the auditor must maintain independence in mental attitude and in appearance in all matter relating to the audit. The importance of independence was emphasized in chapter 1 under the definition of auditing. The **Code of Professional Conduct** and SASs stress the need for independence. CPA firms are required to follow several practices to increase the likelihood of independence of all personnel. For example, there are established procedures on larger audits when there is a dispute between management and the auditors

Due Professional Care: The third general standard involves due care in the performance of all aspects of auditing. Simply stated, this means that auditors are professionals responsible for fulfilling their duties diligently and carefully. Due care includes consideration of the completeness of the audit documentation, the sufficiency of the audit evidence, and the appropriateness of the audit report. As professionals, auditors must not act negligently or in bad faith, but they are not expected to be infallible.

B. Standards of Field Work

The standards of field work concern evidence accumulation and other activities during the actual conduct of the audit.

Adequate/proper Planning and Supervision: The first standard requires that the audit be sufficiently planned to ensure an adequate audit and proper supervision of assistants. Supervision is essential in auditing because a considerable portion of the field work is done by less experienced staff members.

Sufficient understanding of the entity's or auditee's internal control: The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the

risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. To adequately perform an audit, the auditor must have an understanding of the client's business and industry. For example, to audit a bank, an auditor must understand the nature of the bank's operations, federal and state regulations applicable to banks, and risks affecting significant accounts such as loan loss reserves. One of the most widely accepted concepts in the theory and practice of Auditing Princ. and Pract.s the importance of the client's system of internal control for mitigating client business risks, safeguarding assets and records, and generating reliable financial information. If the auditor is convinced that the client has an excellent system of internal control, one that includes adequate internal controls for providing reliable data, the amount of audit evidence to be accumulated can be significantly less than when controls are not adequate. In some instances, internal control may be so inadequate as to preclude conducting an effective audit.

Sufficient, competent and relevant evidence: The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. Decisions about how much and what types of evidence to accumulate for a given set of circumstances require professional judgment.

C. Standards of Reporting

The four reporting standards require the auditor to prepare a report on the financial statements taken as a whole, includes:

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons there for in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

Auditors should prepare written audit reports communicating the results of each audit and they should appropriately issue the reports to make the information available for timely use by management, legislative officials, and other interested parties. The auditor's report should be complete, accurate, objective, convincing, and as clear and concise as the subject permits.

Auditors should report - audit objectives and the audit scope and methodology; significant audit findings, and where applicable, auditors' conclusions; recommendations for action to correct problem areas to improve operations; all significant instances of noncompliance and all significant instances of abuse that were found during or in connection with the audit; illegal acts should be reported directly to parties external to the audited entity; scope of work management controls and any significant weaknesses found; the view of responsible officials of the audit program concerning auditors' findings, conclusions, and recommendations, as well as corrections planned; noteworthy accomplishments, particular when management improvements in one area may be applicable elsewhere; and, significant issues needing further audit work to the auditors responsible for planning future audit work.

Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the report should also be sent to other officials who have legal oversight authority or who may be responsible for action on audit findings and recommendations and to other officials authorized to receive such reports. Unless restricted by law or regulations, copies should be made available for public inspection.

Activity



Dear learner! 1. Distinguish between generally accepted auditing standards and generally accepted accounting principles, and give two examples of each.
2. Try to explain the three main sets of auditing standards?

2.4 Professional Ethics: Fundamental Principles, Threats and Safeguards

Ethics – can be defined broadly as a set of moral principles or values. Each of us has a set of values, although we may not have considered them explicitly. Philosophers, religious organizations and other groups have defined in various ways the idea sets of moral principles and values. Examples of prescribed sets of moral principles or values at the implementation level include laws and regulations, church and mosque doctrine, codes of business ethics for professional groups such as CPAs, and codes of conduct within individual organizations.

Special Needs for Ethics: Ethical behavior is necessary for a society to function in an orderly manner. The underlying reason for a high level of professional conduct by any profession is the need for public confidence in the quality of services rendered by the professions.

Why people act unethically: Most people define **unethical behavior**, as a conduct that differs from what they believe would have been appropriate given circumstances. It is believed that there are two primary reasons why people act unethically:

Person's Ethical Standards Differ from General Society: Extreme examples of people whose behavior violates almost everyone's ethical standards are drug dealers, bank robbers, and larcenists. Most people who commit such acts feel no remorse when they are apprehended because their ethical standards differ from those of society as a whole. There are also many far less extreme examples when others violate our ethical values. When people cheat on their tax returns, treat other people with hostility, lie on resumes and employment applications, or perform below their competence level as employees, most of us regard that as unethical behavior. If the other person has decided that this behavior is ethical and acceptable, there is a conflict of ethical values that is unlikely to be resolved.

The Person Chooses to Act Selfishly: The following example illustrates the difference between ethical standards that differ from general societies and acting selfishly. Person A finds a briefcase in an airport containing important papers and \$1,000. He tosses the briefcase and keeps the money. He brags to his family and friends about his good fortune. Person A's values probably differ from most of societies. Person B faces the same situation but responds differently. He keeps the money but leaves the briefcase in a conspicuous place. He tells nobody and spends the money on a new wardrobe. It is likely that Person B has violated his own ethical standards, but he decided that the money was too important to pass up. He has chosen to act selfishly.

A considerable portion of unethical behavior results from selfish behavior. Political scandals result from the desire for political power; cheating on tax returns and expense reports is motivated by financial greed; performing below one's competence and cheating on tests typically arise from laziness. In each case, the person knows that the behavior is inappropriate but chooses to do it anyway because of the personal sacrifice needed to act ethically.

Ethical Dilemmas

An ethical dilemma is a situation a person faces in which a decision must be made about the appropriate behavior. A simple example includes, finding a diamond ring, which necessitates deciding whether to attempt to find the owner or to keep it, accepting money informally as a tip of corruption, killing or keeping alive the patient who is in agony.

Auditors, accountants, and other business people face many ethical dilemmas in their business careers. Dealing with a client who threatens to seek a new auditor unless an unqualified opinion (auditor's opinion for those organizations present their financial statements fairly) is issued presents a serious ethical dilemma if an unqualified opinion is inappropriate. Deciding whether to confront a supervisor who has materially overstated departmental revenues as a means of receiving a large bonus is difficult ethical dilemma. Continuing to be a part of the management of a company that harasses and mistreats employees or treats customers dishonestly is a moral dilemma, especially if the person has a family to support and the job market is tight.

The common rationalizations of ethical dilemmas include:

1. **Everybody does it** – the argument that it is acceptable to falsify things because it is done by everybody. Examples include, falsify tax returns, cheat on exams, or sell defective products.
2. **If it's Legal, it's Ethical** – using the argument that all legal behavior is ethical relies heavily on the perfection of laws. Under this philosophy, one would have no obligation to return a lost object unless the other person could prove that it was his or hers. Example, abortion.
3. **Likelihood of Discovery and Consequences** – this philosophy relies on evaluating the likelihood that someone else will discover the behavior. Typically, the person also assesses the severity of the penalty (Consequence) if there is a discovery. An example is deciding whether to correct an unintentional over billing to a customer when the customer has already paid the full billing. If the

seller believes that the customer will detect the error and respond by not buying in the future, the seller will inform the customer now; otherwise he/she will wait to see if the customer complains.

Resolving Ethical Dilemmas

In recent years, formal frameworks have been developed to help people resolve ethical dilemmas. The purpose of such a framework is in identifying the ethical issues and deciding on an appropriate course of action using the person's own values. The six-step approach that follows is intended to be a relatively simple approach to resolve ethical dilemma.

1. Obtain the relevant facts.
2. Identify the ethical issues from the facts.
3. Determine who is affected by the outcome of the dilemma and how each person or group is affected.
4. Identify the alternatives available to the person who must resolve the dilemma.
5. Identify the likely consequence of each alternative.
6. Decide the appropriate action.

2 SPECIAL NEED FOR ETHICAL CONDUCT IN PROFESSIONS

Our society has attached a special meaning to the term **professional**. Professionals are expected to conduct themselves at a higher level than most other members of society. For example, when the press reports that a physician, clergyperson, U.S. senator, or CPA has been indicted/formally accused for a crime; most people feel more disappointment than when the same thing happens to people who are not labeled as professionals.

The term **professional** means a responsibility for conduct that extends beyond satisfying individual responsibilities and beyond the requirements of our society's laws and regulations. A CPA, as a professional, recognizes a responsibility to the public, to the client, and to fellow practitioners, including honorable behavior, even if that means regardless of the individual providing it. For the CPA, it is essential that the client and external financial statement users have confidence in the quality of audits and other services. If users of services do not have confidence in physicians, judges, or CPAs, the ability of those professionals to serve clients and the public effectively is diminished.

It is not practical for most customers to evaluate the quality of the performance of professional services because of their **complexity**. A patient cannot be expected to evaluate whether an operation was properly performed. A financial statement user cannot be expected to evaluate audit performance. Most users have neither the competence nor the time for such an evaluation. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and conduct on the part of all practitioners.

CODE OF PROFESSIONAL CONDUCT

The AICPA **Code of Professional Conduct** provides both general standards of ideal conduct and specific enforceable rules of conduct. There are four parts to the code: **principles, rules of conduct, interpretations of the rules of conduct, and ethical rulings**. The parts are listed in order of increasing specificity; the principles provide ideal standards of conduct, whereas ethical rulings are highly specific.

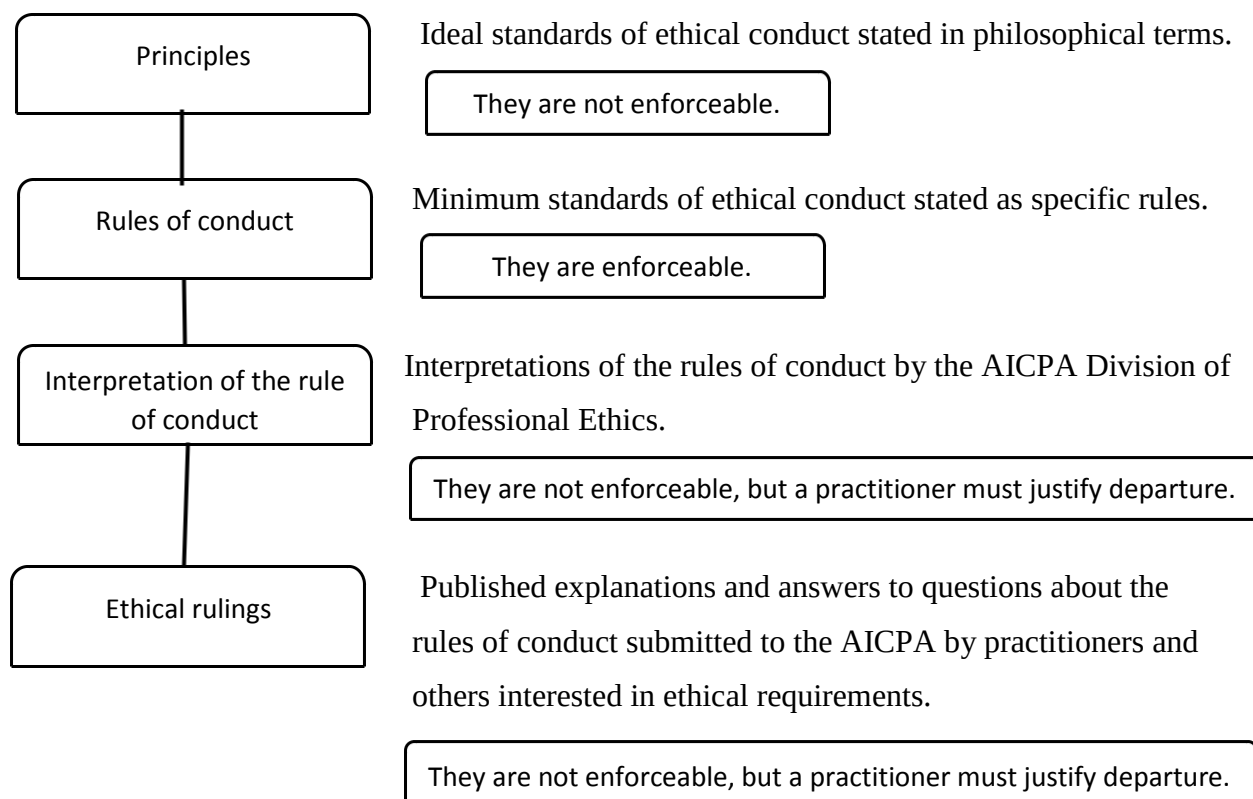


Figure 2 Code of professional conduct

1. Principles of Professional Conduct

The section of the AICPA Code dealing with principles of professional conduct includes a general discussion of characteristics required of a CPA. The principles section consists of two main parts: six ethical principles and a discussion of those principles. The ethical principles are listed in the box below. Discussions throughout this chapter include ideas taken from the principles section.

Ethical Principles

1. **Responsibilities** In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
2. **The Public Interest** Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
3. **Integrity** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
4. **Objectivity and Independence** A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
5. **Due Care** A member should observe the profession's technical and ethical standards, strive continually to improve competence and quality of services, and discharge professional responsibility to the best of the member's ability.
6. **Scope and Nature of Services** A member in public practice should observe the principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

The first five of these principles are equally applicable to all members of the AICPA, regardless of whether they practice in a CPA firm, work as accountants in business or government, are involved in some other aspect of business, or are in education. One exception is the last sentence of objectivity and independence. It applies only to members in public practice, and then only when they are providing attestation services such as audits. The sixth principle, scope and nature of services, applies only to members in public practice. That principle addresses whether a practitioner should provide a certain service, such as providing personnel consulting when an audit client is hiring a chief information officer (CIO) for the client's IT function. Providing such a service can create a loss of independence if the CPA firm recommends a CIO who is hired and performs incompetently.

2. Rules of Conduct

This part of the Code includes the explicit rules that must be followed by every CPA in the practice of public accounting. Those individuals holding the CPA certificate but not practicing public accounting must follow most, but not all requirements. Because the section on rules of conduct is the only enforceable part of the code, it is stated in more precise language than the section on principles. Because of their enforceability, many practitioners refer to the rules as the AICPA **Code of Professional Conduct**. When practitioners conduct themselves at the minimum level, this does not imply unsatisfactory conduct. The profession has presumably set the standards sufficiently high to make the minimum conduct satisfactory.

At what level do practitioners conduct themselves in practice? As in any profession, the level varies among practitioners. Most practitioners conduct themselves at a high level. Unfortunately, a few conduct themselves below the minimum level set by the profession. The activities designed to encourage CPAs to conduct themselves at a high-level help minimize any substandard practice.

3. Ethical Rulings

Rulings are explanations by the executive committee of the professional ethics division of **specific factual circumstances**. A large number of ethical rulings are published in the expanded version of the AICPA **Code of Professional Conduct**. The following is an example (Rule 101—Independence; Ruling No. 16):

- **Question**—A member serves on the board of directors of a nonprofit social club. Is the independence of the member considered to be impaired with respect to the club?
- **Answer**—Independence of the member is considered to be impaired because the board of directors has the ultimate responsibility for the affairs of the club.

RULES OF CONDUCT AND THEIR INTERPRETATIONS

They are explicit rules that must be followed by every CPA in the practice of public accounting. Rules are the only enforceable part of the code, which are stated in more precise language than the section on principles. It may not be necessary to follow all, but CPAs should follow most of the requirements. There are 11 rules of conduct and corresponding interpretations.

Rue 101- independence

A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by council.

CPA firms are required to be independent for certain services that they provide, but not for others. The last phrase in Rule 101, “as required by standards promulgated by bodies designated by Council” is a convenient way for the AICPA to include or exclude independence requirements for different types of services. For example, the Auditing Standards Board requires that auditors of historical financial statements be independent. Rule 101 therefore applies to audits. Independence is also required for other types of attestations, such as review services and audits of prospective financial statements. However, a CPA firm can do tax returns and provide management services without being independent. Rule 101 does not apply to those types of services.

There are more interpretations for independence than for any of the other rules of conduct. Some of the more significant issues and interpretations involving independence are discussed in the following sections.

1. Financial Interests

Interpretations of Rule 101 prohibit covered members from owning **any stock or other direct investment** in audit clients because it is potentially damaging to actual audit independence (independence of mind), and it certainly is likely to affect users’ perceptions of the auditors’ independence (independence in appearance). **Indirect investments**, such as ownership of stock in a client’s company by an auditor’s grandparent, are also prohibited, but **only if the amount is material** to the auditor. The ownership of stock rule is more complex than it appears at first glance. A more detailed examination of that requirement is included to aid in understanding and to show the complexity of one of the rules. There are three important distinctions in the rules as they relate to independence and stock ownership.

1. Covered Members Rule 101 applies to covered members in a position to influence an attest engagement. Covered members include the following:

- a. Individuals on the attest engagement team
- b. An individual in a position to influence the attest engagement, such as individuals who supervise or evaluate the engagement partner
- c. A partner or manager who provides non attest services to the client
- d. A partner in the office of the partner responsible for the attest engagement
- e. The firm and its employee benefit plan
- f. An entity that can be controlled by any of the covered members listed above or by two or more of the covered individuals or entities operating together

2. **Direct versus Indirect Financial Interest** The ownership of stock or other equity shares and debt securities by members or their immediate family is called a **direct financial interest**. For example, if either a partner in the office in which an audit is conducted or the partner's spouse has a financial interest in a company, the CPA firm is prohibited by Rule 101 from expressing an opinion on the financial statements of that company. An **indirect financial interest** exists when there is a close, but not a direct, ownership relationship between the auditor and the client. An example of an indirect ownership interest is the covered member's ownership of a mutual fund that has an investment in a client.
3. **Material or Immaterial:** Materiality affects whether ownership is a violation of Rule 101 only **for indirect ownership**. Materiality must be considered in relation to the member person's wealth and income. For example, if a covered member has a significant amount of his or her personal wealth invested in a mutual fund and that fund has a large ownership position in a client company, a violation of the Code is likely to exist.
4. **Related Financial Interest Issues**
- Several interpretations of Rule 101 deal with specific aspects of financial relationships between CPA firm personnel and clients. These are summarized in this section.
- A. **Former Practitioners:** In most situations, the interpretations permit former partners or shareholders who left the firm due to such things as retirement or the sale of their ownership interest to have relationships with clients of the firm of the type that are normally a violation of Rule 101, without affecting a firm's independence. A violation by the firm would occur if the former partner was held out as an associate of the firm or took part in activities that are likely to cause other parties to believe the person is still active in the firm.
- B. **Normal Lending Procedures:** Generally, loans between a CPA firm or covered members and an audit client are prohibited because it is a financial relationship. There are several exceptions to the rule, however, including automobile loans, loans fully collateralized by cash deposits at the same financial institution, and unpaid credit card balances. It is also permissible to accept a financial institution as a client, even if covered members of the CPA firm have existing home mortgages, other fully collateralized secured loans, and immaterial loans with the institution. No new loans are permitted, however. Both the restrictions and exceptions are reasonable ones, considering the trade-

off between independence and the need to permit CPAs to function as businesspeople and individuals.

C. **Financial Interests and Employment of Immediate and Close Family Members**

The financial interests of immediate family members, defined as a spouse, spousal equivalent, or dependent, are ordinarily treated as if they were the financial interest of the covered member. For example, if the spouse of a professional on the audit engagement team owns any stock in the client, Rule 101 is violated. Independence is also impaired if an immediate family member holds a key position such as financial officer or chief executive officer with the client that allows them to influence accounting functions, preparation of financial statements, or the contents of the financial statements.

Ownership interests of close family members, defined as a parent, sibling, or nondependent child, do not normally impair independence unless the ownership interest is material to the close relative. Imagine the potential difficulty in maintaining independence and objectivity if the firm is asked to audit a client where the parent of the audit partner is chief executive officer and has a significant ownership interest in the client. For individuals on the engagement team, independence is impaired if a close relative has a key position with the client or has a financial interest that is material to the close relative or enables the relative to exercise significant influence over the client. Immaterial ownership interests of close family members, defined as a parent, sibling, or nondependent child, do not normally impair independence. Independence is also not impaired if the covered member is not aware of the close relative's ownership interest.

Similar rules apply to other individuals in a position to influence the audit engagement or partners in the audit-engagement office. However, in these cases, the ownership interest does not impair independence unless the ownership interest is material to the close relative and allows the close relative to exercise significant influence over the audit client.

D. Joint Investor or Investee Relationship with Client Assume, for example, that a CPA owns stock in a non-audit client, Jackson Company. Frank Company, which is an audit client, also owns stock in Jackson Company. This may be a violation of Rule 101.

- i. **Client investor.** If the client's investment in the non-client is material, any direct or material indirect investment by the CPA in the non-client investee impairs independence. If the client's investment is not material, independence is impaired only if the CPA's investment is material.

- ii. **Client investee.** If investment in a client is material to a non-client investor, any direct or material indirect investment by the CPA in the non-client impairs independence. If the non-client's investment in the client is not material, independence is not impaired unless the CPA's investment in the non-client allows the CPA to exercise significant influence over the non-client.

E. **Director, Officer, Management, or Employee of a Company** If a CPA is a member of the board of directors or an officer of a client company, his or her ability to make independent evaluations of the fair presentation of financial statements is affected. Even if holding one of these positions did not actually affect the auditor's independence, the frequent involvement with management and the decisions it makes is likely to affect how statement users perceive the CPA's independence. To eliminate this possibility, interpretations prohibit covered members, partners, and professional staff in the office of the partner responsible for the attest engagement from being a director or officer of an audit client company. Similarly, the auditor cannot be an underwriter, voting trustee, promoter, or trustee of a client's pension fund, act in any other capacity of management, or be an employee of the company.

Independence can also be impaired when a former partner or member of the audit firm leaves the firm and is employed by the client in a key position, unless certain conditions are met. For example, the audit engagement team may need to modify audit procedures to reduce the risk that the former employee has knowledge of the audit plan, and the firm will need to evaluate whether members of the engagement team can maintain an effective level of professional skepticism when evaluating audit information and other representations provided by the former firm member. Independence can also be impaired when a member of the audit team discusses potential employment or receives an offer of employment from the audit client. In those situations, independence can be preserved if the individual promptly reports the offer to appropriate firm personnel and is removed from the engagement until the offer is accepted or rejected.

Interpretations permit CPAs to do audits and be **honorary** directors or trustees for not-for-profit organizations, such as charitable and religious organizations, as long as the position is purely honorary. To illustrate, it is common for a partner of the CPA firm doing the audit of a city's United

Fund drive to also be an honorary director, along with many other civic leaders. The CPA cannot vote or participate in any management functions.

5. Litigation between CPA Firm and Client

When there is a lawsuit or intent to start a lawsuit between a CPA firm and its client, the ability of the CPA firm and client to remain objective is questionable. The interpretations regard such litigation as a violation of Rule 101 for the current audit. For example, if management sues a CPA firm claiming a deficiency in the previous audit, the CPA firm is not considered independent for the current year's audit. Similarly, if the CPA firm sues management for fraudulent financial reporting or deceit, independence is lost. The CPA firm and client company or management may be defendants in a suit brought by a third party, such as in a securities class action. This litigation in itself does not affect independence. However, independence may be affected if cross-claims between the auditor and client are filed that have a significant risk of a material loss to the CPA firm or client.

Litigation by the client related to tax or other non-audit services, or litigation against both the client and the CPA firm by another party, does not usually impair independence. The key consideration in all such suits is the likely effect on the ability of client, management, and CPA firm personnel to remain objective and comment freely.

6. Bookkeeping and Other Services

If CPA records transactions in the journals for the client, posts monthly totals to the general ledger, makes adjusting entries, and subsequently does an audit, there is some question as to whether the CPA can be independent in the audit role. The interpretations **permit a CPA firm to do both bookkeeping and auditing for a private company audit client.** The AICPA's conclusion is presumably based on a comparison of the effect on independence of having both bookkeeping and auditing services performed by the same CPA firm with the additional cost of having a different CPA firm do the audit. There are three important requirements that the auditor must satisfy before it is acceptable to do bookkeeping and auditing for the client:

- a. The client must accept full responsibility for the financial statements. The client must be sufficiently knowledgeable about the enterprise's activities, financial condition, and the applicable accounting principles so that the client can reasonably accept such responsibility, including the fairness of valuation and presentation and the adequacy of disclosure. When

necessary, the CPA must discuss accounting matters with the client to be sure that the client has the required degree of understanding.

- b. The CPA must not assume the role of employee or of management conducting the operations of an enterprise. For example, the CPA cannot consummate transactions, have custody of assets, or exercise authority on behalf of the client. The client must prepare the source documents on all transactions in sufficient detail to identify clearly the nature and amount of such transactions and maintain accounting control over data processed by the CPA, such as control totals and document counts.
- c. The CPA, in making an audit of financial statements prepared from books and records that the CPA has maintained completely or in part, must conform to auditing standards. The fact that the CPA has processed or maintained certain records does not eliminate the need to make sufficient audit tests.

7. Consulting and Other Non-audit Services

CPA firms offer many other services to attest clients that may potentially impair independence. Such activities are permissible as long as the member does not perform management functions or make management decisions. For example, a CPA firm may assist in the installation of a client's information system as long as the client makes necessary management decisions about the design of the system. Subject to some restrictions, CPA firms may also provide internal auditing and other extended auditing services to their clients as long as management maintains responsibility for the direction and oversight of the internal audit function.

8. Unpaid Fees

Under Rule 101 and its rulings and interpretations, independence is considered impaired if billed or unbilled fees remain unpaid for professional services provided more than 1 year before the date of the report. Such unpaid fees are considered a loan from the auditor to the client and are therefore a violation of Rule 101. Unpaid fees from a client in bankruptcy do not violate Rule 101.

OTHER RULES OF CONDUCT.

Integrity and Objectivity: Integrity means impartiality in performing all services. Rule 102 on integrity and objectivity is presented below:

Rule 102—Integrity and Objectivity In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

Technical Standards

The next three standards of the Code relate to the auditor's adherence with the requirements of technical standards. The following are the requirements of the technical standards:

Rule 201—General Standards: A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

A. Professional competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

B. Due professional care. Exercise due professional care in the performance of professional services.

C. Planning and supervision. Adequately plan and supervise the performance of professional services. **D. Sufficient relevant data.** Obtain sufficient, relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Rule 202—Compliance with Standards A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

Rule 203—Accounting Principles A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Confidentiality

Rule 301—Confidential Client Information: A member in public practice shall not disclose any confidential client information without the specific consent of the client.

This rule shall not be construed (1) to relieve a member of his or her professional obligations under Rules 202 and 203, (2) to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy.

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

Need for Confidentiality During audits and most other types of engagements, practitioners obtain considerable confidential information, including officers' salaries, product pricing and advertising plans, and product cost data. If auditors divulge this information to outsiders or to client employees who have been denied access to the information, their relationship with management can be seriously strained, and in extreme cases, the client can be harmed. The confidentiality requirement applies to all services provided by CPA firms, including tax and management services. Ordinarily, the CPA's audit files can be made available to someone else only with the express permission of the client. This is the case even if a CPA sells the practice to another CPA firm or is willing to permit a successor auditor to examine the audit documentation prepared for a former client.

Exceptions to Confidentiality As stated in the second paragraph of Rule 301, there are four exceptions to the confidentiality requirements. All four exceptions concern responsibilities that are more important than maintaining confidential relations with the client.

1. **Obligations related to technical standards.** Suppose that 3 months after an unqualified audit report was issued, the auditor discovers that the financial statements were materially misstated. When the chief executive officer is confronted, he responds that even though he agrees that the financial statements are misstated, confidentiality prevents the CPA from informing anyone. Rule 301 makes it clear that the auditor's responsibility to discharge professional standards is greater than that for

confidentiality. In such a case, a revised, correct audit report must be issued. Note, however, that the conflict seldom occurs.

2. **Subpoena or summons and compliance with laws and regulations.** Legally, information is called **privileged information** if legal proceedings cannot require a person to provide the information, even if there is a subpoena. Information communicated by a client to an attorney or by a patient to a physician is privileged. **Information obtained by a CPA from a client generally is not privileged.** Exception (2) of Rule 301 is therefore needed to put CPA firms in compliance with the law.

3. **Peer review.** When a CPA or CPA firm conducts a peer review of the quality controls of another CPA firm, it is normal practice to examine several sets of audit files. If the peer review is authorized by the AICPA, state CPA society, or state Board of Accountancy, client permission to examine the audit documentation is not needed. Requiring permission from each client may restrict access of the peer reviewers and would be a time burden on all concerned. Naturally, the peer reviewers must keep the information obtained confidential and cannot use the information for other purposes.

4. **Response to ethics division.** If a practitioner is charged with inadequate technical performance by the AICPA Ethics Division trial board under any of Rules 201 to 203, board members are likely to want to examine audit documentation. Exception (4) in Rule 301 prevents a CPA firm from denying the inquirers access to audit documentation by saying that it is confidential information. Similarly, a CPA firm that observes substandard audit documentation of another CPA firm cannot use confidentiality as the reason for not initiating a complaint of substandard performance against the firm.

Contingent Fees

Rule 302—Contingent Fees A member in public practice shall not:

- 1) Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the member or member's firm performs:
 - a) an audit or review of a financial statement; or
 - b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
 - c) an examination of prospective financial information; or
- 2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

The prohibition in (1) above applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. A member's fees may vary depending, for example, on the complexity of services rendered.

Discreditable Acts

Rule 501—Acts Discreditable A member shall not commit an act discreditable to the profession.

Because of the special need for CPAs to conduct themselves in a professional manner, the *Code* has a specific rule prohibiting acts discreditable to the profession, although a discreditable act is not well defined in the rules or interpretations.

Discreditable acts include:

- ❖ retention of client's records,
- ❖ discrimination or harassment in employment practice,
- ❖ breaking government standards and
- ❖ Disclosing CPA examination questions and answers.

Rule 501 applies to all CPAs, even those not in public practice. For example, a member is considered to have committed an act discreditable if by his or her negligence others are made or permitted or directed to make materially false and misleading entries in the financial statements and records of an entity, the member fails to correct financial statements that are materially false and misleading, or the member signs or permits or directs another to sign a document containing materially false and misleading information. Also, if a member prepares financial statements or related information for reporting to governmental bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to requirements of accounting standards. Other interpretations of Rule 501 describe additional acts considered to be discreditable:

1. Compliance with standards on government audits and requirements of government bodies and agencies. Audits of government units and federal grant recipients must be done in compliance with

government auditing standards, in addition to GAAS. When a member accepts an engagement that involves reporting to a regulatory agency such as the SEC, the member must follow the additional requirements of the regulatory agency, in addition to auditing standards. If the additional requirements are not followed, the reasons should be noted in the report.

2. Inclusion of indemnification clauses in engagement letters. Certain governmental bodies, such as federal banking regulators, state insurance commissions, and the SEC prohibit entities they regulate from including certain types of indemnification and limitation of liability provisions in agreements related to the performance of audit or other attest services. Members violate Rule 501 if they include such provision in their engagement letters related to the performance of audit or attest services for these entities.

Advertising and Other Forms of Solicitation

Rule 502—Advertising and Other Forms of Solicitation A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited.

Solicitation consists of the various means that CPA firms use to engage new clients other than accepting new clients who approach the firm. Examples include taking prospective clients to lunch to explain the CPA's services, offering seminars on current tax law changes to potential clients, and advertising in the Yellow Pages of a phone book. The last example is advertising, which is only one form of solicitation.

Commissions and Referral Fees

Commissions are compensation paid for recommending or referring a third party's product or service to a client or recommending or referring a client's product or service to a third party. Restrictions on commissions are similar to the rules on contingent fees. CPAs are prohibited from receiving commissions for a client who is receiving attestation services from the CPA firm. Commissions are permissible for other clients, but they must be disclosed. Referral fees for recommending or referring the services of another CPA are not considered commissions and are not restricted. However, any referral fees for CPA services must also be disclosed.

Rule 503—Commissions and Referral Fees

A. Prohibited commissions. A member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommend or refer any product or service

to be supplied by a client, or receive a commission, when the member or the member's firm also performs for that client:

- a) an audit or review of a financial statement; or
- b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
- c) an examination of prospective financial information.

This prohibition applies during the period in which the member is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in such listed services.

B. *Disclosure of permitted commissions.* A member in public practice who is not prohibited by this rule from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission relates.

C. *Referral fees.* Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.

Rule 505—Form of Organization and Name A member may practice public accounting only in a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council. A member shall not practice public accounting under a firm name that is misleading. Names of one or more past owners may be included in the firm name of a successor organization. A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its CPA owners are members of the Institute.

2.5 Legal Liability of Auditors

2.5.1 Criminal Liability and Civil Liability

CPAs are subject to all laws that govern behavior generally. Additionally, auditors must take legal responsibility for their examinations and the reports they render. As a result of his work as professional accountant, a CPA may incur either criminal liability, civil liability or both.

2.5.1.1. Criminal Liability

A few CPAs have been convicted of crimes. Usually, these convictions have resulted from acts that not related to independent auditing and that are popularly thought of as criminal conduct. For example, several CPAs have been found guilty of bribery of tax agents or filing of false tax returns for clients. However, in some cases, CPAs have faced the thread of criminal action or alleged audit failure when they were not alleged to have benefited directly from their wrongdoing. Several auditors have now been convicted of willfully expressing unqualified opinions on financial statements that they knew, or should have known, were false in material respects. The alleged motivation for this conduct was a desire to avoid exposure of inadequacies in past audits. In such cases, the distinction between criminal and civil liability seems to rest entirely on a jury's assessment of the good faith of auditors in fulfilling their duties.

2.5.1.2. Civil Liability

The auditor's civil liability may be either to his client or to third parties that rely on his professional opinion. His liability to third parties maybe defined either by previous legal decisions – common law or by statue – statutory law.

Liability to Clients Under Common Law

When an independent auditor is engaged to perform work for fee, the relationship that arises depends on the contract. The auditor's duty of care and skill is rarely expressly defined in the contract, but the law always attaches to the contract an implied obligation to perform the work undertaken with reasonable skill and care. An action by the client against an independent auditor is an action for breach of contract and only the client, who is party to the contract, can sue for breach of it. Contractual liability arises under common law.

An example of breach of a specific contract provisions would be failure to file on time when an auditor has agreed to file tax refund claims for his client. An example of breach of an implied obligation would be negligent failure to detect a material misstatement in financial statements caused by fraud on the part of client's employee.

Negligence results when the auditor fails to conform to the standard of care that the law requires. In negligence actions the plaintiff has the burden of proof; hence, the client must prove the auditor's failure to exercise that necessary care. In his defense, the auditor may prove the contributory negligence of the

client. The reasonable care which the auditor owes to the client is that degree of skill and care which would ordinarily be exercised by other members of the profession in similar circumstances. In essence, this means adherence to generally accepted auditing standards. Failure to exercise due care is referred to as ordinary negligence. Of course, the auditor is also liable to his client for gross negligence flagrant or reckless departure from the standard of due care – and for fraud – intentional misstatement or concealment of material fact.

There is also an implicit fiduciary relationship between the auditor and his client. During the course of his examination the auditor ordinarily acquires a good deal of confidential information about the client. If this information is arbitrarily disclosed to others by the auditor, the fiduciary relationship would be reached and the auditor would be liable to the client for any damages resulting from the disclosure. The auditor would also be subject the disciplinary action by his professional associations for violations of an ethical rule.

Liability to Third Parties Under Common Law

The auditor owns a duty to third parties whose reliance is foreseen by the auditor. The third party is a person who is not the member with the parties to a contract. Third parties can be classified as primary beneficiaries and other or general third beneficiaries. A primary beneficiary is the one about whom the auditor is informed prior to conducting audit. The auditor is liable to more general third parties for gross negligence and fraud. Gross negligence is understood to mean exercise due professional care with intent to deceive-which encompasses failure to uncover (detect) fraud/failure to exercise due professional care.

The independent auditor's duty to those who are not his clients is another matter. An auditor may owe a duty of care to those who are not, in the ordinary sense, his clients, such as shareholders, bankers, government, creditors and others. A negligent, though honest, misrepresentation may give rise to an action for damages for financial loss. Apart from any contractual or fiduciary relationship, such an action seeks to establish a twisting liability for negligent misstatement.

The degree of negligence required to establish the auditor's liability to third parties under common law varies from one jurisdiction (e.g., state) to another. Three general approaches may use to summarize auditor's liability to third parties under common law in the various state's courts.

1) Ultra mares

2) Restatement of Torts and

3) Rosenblum.

1. **Ultra-mares Approach:** The most widely cited common law precedent stems from the landmark case, *Ultra mares Vs Touché & Co.* (1931). In this case, the defendant CPAs issue an unqualified opinion on the balance sheet of a company engaged in the importation and sale of rubber. On the basis of the CPAs opinion, *Ultra mares*, a factor, made several loans to the company. Shortly thereafter, the company was declared bankrupt, and *Ultra mares* sued the CPAs for ordinary negligence.

The New York Court of Appeals (the state's highest court) ruled that the CPAs should be held liable for ordinary negligence only to third client and any third party (beneficiary) specifically identified as a user of the CPAs' report. The court went on to indicate that the auditors should be held liable to unidentified third-party user of the audit report for gross negligence or fraud. In the *Ultra mare's* case, the audit was performed "primarily for the benefit" of the client; *Ultra mares* was not specifically identified as a user of the audit report. Therefore, to recover its losses, *Ultra mares* would have been required to prove that CPAs were grossly negligent in performing their audits. The case eventually was settled out of court, with the no determination as to whether the auditors had been grossly negligent.

2. **Restatement of Torts Approach:** The principle of auditor liability for ordinary negligence to a limited class of foreseen third parties is supported by the American Law Institute's Second Restatement of the Law of Torts, which serves as a guide to judges in making common law rulings. The Restatement of Law and Trots approach, also referred to as the foreseen third-party approach, expands the auditors' liability for ordinary negligence to include third parties of a limited class of known or intended users of the audited financial statements. The specific identity of these third parties need not be known to the CPA. The courts in many states have followed this principle including a court of Rhode Island in the leading case of *Ruscha Factors*

Inc., Vs Levin (1968). In that case, the CPAs were found liable for ordinary negligence to a third party that subsequently provided financing to the audit client. The third party had not been specifically identified to the CPAs, although they were aware that the financial statements were to be used to help obtain the financing.

3. **Rosenblum Approach:** In 1983 the New Jersey Supreme Court rejected both as the *Ultra mares* and Restatement of Torts approaches and established a very different standard in the case of *Rosenblum vs.*

Adler. In this case, the defendant CPAs issued an unqualified report on the financial statements of Giant Stores Corporation which showed the corporation to be profitable. In reliance upon these statements, Rosenblum sold a catalog showroom business to Giant in exchange for shares of Giant's stock. Shortly afterward, Giant filed for bankruptcy and the stock became worthless, Rosenblum sued Giant's CPAs, alleging ordinary negligence. The case was dismissed by the trial court, on the premise that the CPAs were not liable to unidentified third parties for ordinary negligence. However, the New Jersey Supreme Court reversed the lower court, finding that CPAs, can be held liable for ordinary negligence to any third party the auditors could "reasonable foresee" as recipients of the statements for routine business purposes. This approach, also referred to as the foreseeable third – party approach, has the potential effect of expanding CPA liability to third parties whose purposes are totally unknowns to the CPAs.

Liability to Third Parties Under Statutory Law

Statutory law is written law, created by state or federal legislative bodies. Most states have "blue-sky" laws, which regulate the issuance and trading of securities within the state. The two most important federal laws relative to auditors' liability are the Securities Act 1933 (1933 Act) and the Securities Exchange Act 1934 (1934 Act). Under the Securities Act of 1933 and the Securities Exchange Act 1934 the auditor's liabilities to third parties was extended. The effect of Section 11 of the 1933 Act has been summarized by the Levy as follows:

- (1) Any person acquiring securities described in the Registration Statement may sue the accountant, regardless of the fact that he is not the client of the accountant.
- (2) His claim may be based upon an alleged false statement or misleading omission in the financial statements, which constitutes his prima facie case. The plaintiff does not have the further burden of proving that the accountants were negligent or fraudulent in certifying to the financial statements involved.
- (3) The plaintiff does not have to prove that he relied upon the statement or that loss which he suffered was the proximate result of the falsity or misleading character of the financial statement.
- (4) The accountant has thrust upon him the burden of establishing his freedom from negligence and fraud by providing that he had, after reasonable investigation, reasonable ground to believe and did believe that the financial statements to which he certified, were true not only as of the date of the financial statements, but beyond that, as of the time when the Registration Statement became effective.

(5) The accountant has the burden of establishing by way of defense or in reduction of alleged damages that the loss of the plaintiff resulted in whole or in part from cases other than the false statements or the misleading omissions in the financial statements. Under the common law it would have been part of the plaintiff's affirmative case to prove that the damages which he claims he sustained were proximately caused by the negligence or fraud of the accountant.

On the other hand, the Exchange Act, which concerns the filing of annual reports with the SEC, does not expose auditors to a liability significantly different from the common law. In contrast to Section 11 of the 1933 Act, Section 18 of the 1934 Act (1) has no provision for extending liability to an "effective date," (2) requires the plaintiff to prove that he relied on the financial statements

and that such reliance was the cause of his damages, and (3) does not require the auditor to prove his absence of negligence, but merely requires him to prove that he acted in good faith they had no knowledge that the statements were false or misleading.

Section 10(b) and Rule 10b-5 of the Exchange Act are sufficiently broad to serve as a basis of action against auditors, although auditors are not specifically mentioned in the section or rule. Clause (b) of the rule requires a plaintiff to establish that "any person" has made "any untrue statement of material fact" or has omitted "to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

Auditors' Liability to Clients

Auditors should fulfil the implied or expressed contracts with clients. They are liable to their clients for negligence and/or breach of contract should they fail to provide the services or not exercise due care in their performance. An auditor may be liable to a client for breach of contract or wrongful act when he/she:

- Issue a standard audit report when he or she has not made an examination in accordance with GAAS
- Doesn't deliver the audit report by the agreed upon date
- Violates the client's confidential responsibility
- Fails to exercise due care, that is reasonably expected from him/her
- Intentionally deceits, such as misinterpretation concealment or non-disclosure of material fact, that results damage to another
- Breaches the contract

Activity

Dear learners!

1. Write and explain the three general approaches may use to summarize auditor's liability to third parties under common law in the various states court.
2. Explain the Auditors' Liability to Clients.
3. what is the difference between the two most important federal laws relative to auditors' liability of the Securities Act 1933 (1933 Act) and the Securities Exchange Act 1934 (1934 Act)?

2.5 Rights and Duties, Appointment, Dismissal and Resignation of an Auditor

2.5.1 Rights of an auditor

1. Company auditor has rights to access the books and records of the company. He can refer to any book.
2. Company auditor has right to get explanations from company staff. If such explanations are not received, he qualifies his report.
3. Company auditor has right to receive notice of general meetings. He can attend the general meetings.
4. Company auditor has right to visit branches. But there should be no separate auditors to those branches and it should be a home branch.
5. Company auditor has right to seek legal and technical advises. But, in his report, he should express his own opinion but not that of expert's concern.
6. Company auditor has right to claim remuneration. His remuneration will be fixed by appointing authority and it will be paid by company.
7. Company auditor has right to refuse to commence the audit. Till making the records up to date, he cannot start his work.

8. Company auditor has right to question the board. Board also should give explanation to him.
9. Company auditor has right to qualify his report. If he comes across any dis-satisfactory point, he can mention the same in his report.
10. Company auditor has right of indemnity. He can reimburse expenses incurred by him in connection with conduction of audit work.

2.5.2 Duties of an auditor

The duties of an auditor have been laid down by the Companies Act, 2013, provided in Section 143. The Act explains the duties in a simplified manner, although the list given is not exhaustive.

1. Prepare an Audit Report

An audit report, in simple terms, is an appraisal of a business's financial position. The auditor is responsible for preparing an audit report based on the financial statements of the company. The books of accounts so examined by him should be maintained in accordance with the relevant laws. He must ensure that the financial statements comply with the relevant provisions of the Companies Act 2013, relevant Accounting Standards etc. In addition to this, it is imperative that he ensures that the entity's financial statements depict a true and fair view of the company's financial position.

2. Form a negative opinion, where necessary

The auditor's report has a high degree of assurance and reliability because it contains the auditor's opinion on the financial statements. Where the auditor feels that the statements do not depict a true and fair view of the financial position of the business, he is also entitled to form an adverse opinion on the same. Additionally, where he finds that he dissatisfied with the information provided and finds that he cannot express a proper opinion on the statements, he will issue a disclaimer of opinion. A disclaimer of opinion basically indicates that due to the lack of information available, the financial status of the entity cannot be determined. However, it is to be noted that the reasons for such negative opinion is also to be specified in the report.

3. Make inquiries

One of the auditor's important duties is to make inquiries, as and when he finds it necessary. A few of the inquiries include: -

- a. Whether loans and advances made on the basis of security are properly secured and the terms

relating to the same are fair.

- b. Whether any personal expenses (expenses not associated with the business) are charged to the Revenue Account.
- c. Where loans and advances are made, they are shown as deposits.
- d. Whether the financial statements comply with the relevant accounting standards

4. Lend assistance in case of a branch audit

Where the auditor is the branch auditor and not the auditor of the company, he will lend assistance in the completion of the branch audit. He shall prepare a report based on the accounts of the branch as examined by him and then send it across to the company auditor. The company auditor will then incorporate this report into the main audit report of the company. In addition to this, on request, if he wishes to, he may provide excerpts of his working papers to the company auditor to aid in the audit.

5. Comply with Auditing Standards

The Auditing Standards are issued by the Central Government in consultation with the National Financial Reporting Authority. These standards aid the auditor in performing his audit duties with relevant ease and accuracy.

It is the duty of the auditor to comply with the standards while performing his duties as this increases his efficiency comparatively.

6. Reporting of fraud

Generally, in the course of performing his duties, the auditor may have certain suspicions with regard to fraud that's taking place within the company, certain situations where the financial statements and the figures contained therein don't quite add up. When he finds himself to be in such situations, he will have to report the matter to the Central Government immediately and in the manner prescribed by the Act.

7. Adhere to the Code of Ethics and Code of Professional Conduct

The auditor, being a professional, must adhere to the Code of Ethics and the Code of Professional Conduct. Part of this involves confidentiality and due care in the performance of his duties. Another important requisite is professional skepticism. In simple words, the auditor must have a questioning mind, must be alert to possible mishaps, errors and frauds in the financial statements.

8. Assistance in an investigation

In the case where the company is under the scope of an investigation, it is the duty of the auditor to provide assistance to the officers as required for the same.

Hence, it can be seen that the duties of the auditor are pretty diverse, it has an all-round and far-reaching impact. The level of assurance provided by a set of audited financial statements is comparatively far higher as compared to regular unaudited financial statements.

2.5.3 Appointment of an auditor

The first auditor of a company would usually be appointed by the directors, or alternatively the shareholders may appoint the auditor at the first Annual General Meeting (“AGM”). Auditors are appointed at the AGM and hold office from the conclusion of the AGM to the conclusion of the next AGM. A retiring auditor shall be re-appointed without any resolution being passed unless:

He is not qualified for re-appointment;

A resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed; or He has given the company notice in writing of his unwillingness to be re-appointed

Appointment by directors

The board of directors shall appoint the first auditor(s) of the company within One Month of the Date of Registration of the company.

The directors have been empowered to fill any casual vacancy in the office of an auditor, except which is caused by prior resignation of an auditor.

Appointment by shareholders

In case the directors fail to appoint the first auditor(s), the shareholders shall do so at a general meeting by passing a resolution.

Subsequent auditors:

- (i) By Ordinary Resolution
- (ii) By Special Resolution

If a casual vacancy in the office of an auditor arises by his resignation, such vacancy should only be filled by the company in a General Meeting.

Appointment by central government

If a company, at an annual general meeting, fails to appoint or re-appoint an auditor, the Central Government may appoint a person to fill the vacancy. The company has to give notice of the above fact to the Government within 7 days of the Annual General Meeting. The appointment by the Central Government is made from the panel of names suggested by the applicant company.

2.5.4 Dismissal and Resignation of an Auditor

Where an auditor ceases to hold office either by resignation or removal, the auditor and the company is obliged under Regulation 62 of SI No. 220 of 2010 (European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010 to notify the Irish Auditing and Accounting Supervisory Authority (“IAASA”) within one month of the date of cessation.

When an auditor resigns before the end of their term or state that they do not wish to be reappointed, they must explain this in a notice to the Companies Registration Office (“CRO”) within 14 days. Under Section 185 (1) of the Companies Act 1990, the notice should state whether there are any circumstances connected with their resignation which should be brought to the attention of the company’s members or creditors. This notice is made public.

If there are circumstances which the auditor considers should be brought to the attention of the company’s members or creditors of the company, the company must, within 14 days either send a copy of the notice to all those who are entitled to receive copies of the statutory accounts, or apply to the court for relief from such requirement.

Where the auditors’ notification specifies that there are no such circumstances, it must be accompanied by a statement of the reasons for the auditors’ resignation.

When an auditor is being removed from office, they have the right to require the directors of a company to convene an Extraordinary General Meeting (“EGM”) of the company to consider the circumstances of removal. The auditor also has the right to make written representations to the company and require their circulation to the members and others who have a right to receive notice of the EGM.

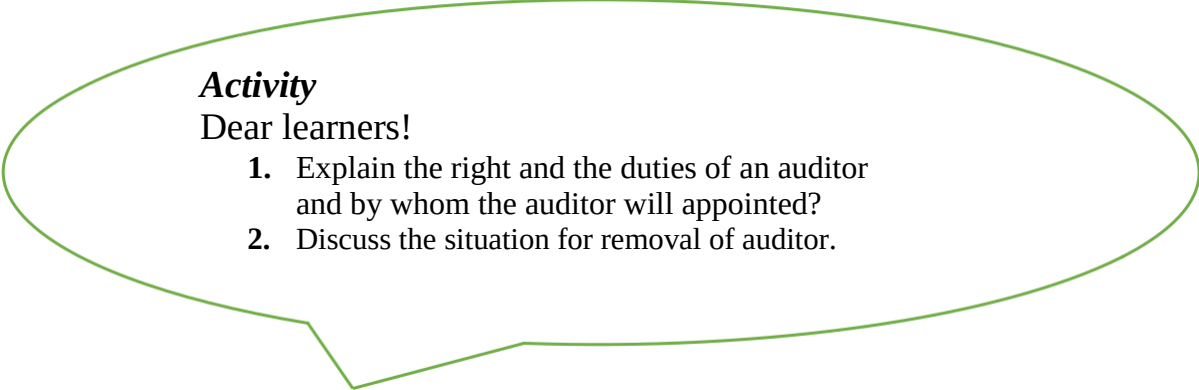
The IAASA must be provided with a copy of the resolution removing the auditor and a copy of any representations made to the company which were provided to the company members. Notice of removal of an auditor must also be notified to the CRO on a Statutory Form H3 within 14 days of the resolution being passed.

There are exceptions to the requirement to notify IAASA on cessation of office by an auditor where the cessation of office by an auditor is due to a company:

- Becoming audit exempt;
- Being liquidated; or
- Being struck off the Companies' Register.

Grounds for Auditor Removal

There must be substantial grounds for removing an auditor and the removal has to be in the best interests of the company which does not include any illegal or improper motive with regard to avoiding disclosures or detection of any failure to comply with the Companies Acts.



Activity

Dear learners!

1. Explain the right and the duties of an auditor and by whom the auditor will appointed?
2. Discuss the situation for removal of auditor.

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CHAPTER SUMMARY

This chapter discussed about Auditing standards that are general guidelines to aid auditors in fulfilling their professional responsibilities. They include consideration of professional qualities such as competence and independence, reporting, requirements, and evidence. Generally, the three main sets of auditing standards and quality standards are summarized as follows:

International Standards on Auditing (ISAs): statements issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants to promote international acceptance of auditing standards. Generally accepted auditing standards (GAAS):10 auditing standards, developed by the AICPA, consisting of general standards, standards of field work, and standards of reporting, along with interpretations; often called *auditing standards*. Statements on Auditing Standards (SASs): pronouncements issued by the AICPA to interpret generally accepted auditing standards. Public Company Accounting Oversight Board (PCAOB): Act to oversee auditors of public companies, including establishing Auditing and quality control standards and performing inspections of registered accounting firms. Quality control: methods used by a CPA firm to ensure that the firm meets its professional responsibilities to clients and others. Additionally, auditor's legal liability in the work as professional accountant, a CPA may incur either criminal liability, civil liability or both. The right and duties that the auditor must perform.

SELF TEST QUESTIONS**PART I- TRUE OR FALSE**

Say 'true' if the statement is correct and 'false' if it is wrong.

1. ISAs do not override a country's regulations governing the audit of financial or other information, as each country's own regulations generally govern audit practices.
2. International Standards on Auditing Princ. and Pract.s statements issued by the Inter - national Auditing and Assurance Standards Board of the International Federation of Accountants to promote international acceptance of auditing standards
3. Written audit reports are to be submitted by the audited organization to the appropriate officials.
4. Proper planning can lead to a more effective audit that is more likely to detect material misstatements if they exist.
5. Copies of audit report should be made available for public inspection even if restricted by law or regulations to do so.

PART II: FILL THE BLANK SPACE

Fill the blank space using the correct word!

1. _____ methods used by a CPA firm to ensure that the firm meets its professional responsibilities to clients and others.
2. The _____ standards concern evidence accumulation and other activities during the actual conduct of the audit.
3. _____ and _____ considered as minimum standards of performance by practitioners rather than as maximum standards or ideals.
4. _____ are statements used to interpret the 10 generally accepted auditing standards and have the status of GAAS and are often referred to as auditing standards or GAAS, even though they are not part of the 10 generally accepted auditing standards.
5. _____ is a standard of field work which states decisions about how much and what types of evidence to accumulate for a given set of circumstances require professional judgment.

PART III. SHORT ANSWER

Give brief and neat answers for the following questions (give further explanation if needed)

1. Describe the role of International Standards on Auditing-----

2. What is the relationship between International Standards on Auditing and U.S. Generally Accepted Auditing Standards?-----

3. What is meant by the term *quality control* as it relates to a CPA firm?-----

4. The first standard of field work requires the performance of the audit by a person or persons having adequate technical training and proficiency as an auditor. What are the various ways in which auditors can fulfill the requirement of the standard?-----

5. State the four major types of services CPAs perform, and explain each.-----

CHAPTER THREE

MATERIALITY AND RISK ASSESSMENT

3.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- ❖ Apply the concept of materiality to the audit.
- ❖ Define risk in auditing.
- ❖ Describe the audit risk model and its components.

3.1. INTRODUCTION

An audit conducted in accordance with auditing standards generally accepted in the United States of America. Those standards require that plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The phrase obtain reasonable assurance is intended to inform users that auditors do not guarantee or ensure the fair presentation of the financial statements. Some risk that the financial statements are not fairly stated exists, even when the opinion is unqualified. The phrase free of material misstatement is intended to inform users that the auditor's responsibility is limited to material financial information. Materiality is important because it is impractical for auditors to provide assurances on immaterial amounts. Materiality and risk are fundamental to planning the audit and designing an audit approach. In this chapter, we will show how these concepts fit into the planning phase of the audit. In this chapter, we apply both materiality and risk. When auditors decide materiality and assess risks, they use a considerable amount of the information acquired and documented during the first four parts of audit planning.

3.2 Materiality

Materiality is a major consideration in determining the appropriate audit report to issue. FASB Concept Statement 2 defines **materiality** as:

- The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it *probable* that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Because auditors are responsible for determining whether financial statements are materially misstated, they must, upon discovering a material misstatement, bring it to the client's attention so that a correction can be made. If the client refuses to correct the statements, the auditor must issue a qualified or an adverse opinion, depending on the materiality of the misstatement. To make such determinations, auditors depend on a thorough knowledge of the application of materiality.

Auditors follow two closely related steps in applying materiality at the planning phase. These two steps, which are part of planning, are our primary focus for the discussion of materiality in this topic. These are,

Step 1 set preliminary judgment about materiality

Step 2 Allocate preliminary judgments about materiality to segments

Step 1 set preliminary judgment about materiality

Auditing standards require auditors to decide on the combined amount of misstatements in the financial statements that they would consider material early in the audit as they are developing the overall strategy for the audit. We refer to this as the preliminary judgment about materiality. It is called a preliminary judgment about materiality because, although a professional opinion, it may change during the engagement. This judgment must be documented in the audit files. Several factors affect the auditor's preliminary judgment about materiality for a given set of financial statements. The most important of these are:

Materiality is a relative rather than an absolute concept: A misstatement of a given magnitude might be material for a small company, whereas the same dollar misstatement could be immaterial for a large one. This makes it impossible to establish dollar-value guidelines for a preliminary judgment about materiality that are applicable to all audit clients.

Bases are needed for evaluating materiality: Because of materiality is relative, it is necessary to have bases for establishing whether misstatements are material. Net income before tax is often the primary base for deciding the materiality for profit-oriented businesses, because it is regarded as a critical item of information for users. Some firms use a different primary base, because net income often fluctuates considerably from year to year and therefore does not provide a stable base, or when the entity is a not-for profit organization. Other primary bases include net sales, gross profit, and total or net assets. After establishing a primary base, auditors should also decide whether the misstatements could materially affect the reasonableness of other bases such as current assets, total assets, current liabilities, and owners' equity. Auditing standards require the auditor to document in the audit files the basis used to determine the preliminary judgment about materiality.

Assume that for a given company, an auditor decided that a misstatement of income before taxes of birr 100,000 or more would be material, but a misstatement would need to be birr 250,000 or more to be material for current assets. It is not appropriate for the auditor to use a preliminary judgment about materiality of birr 250,000 for both income before taxes and current assets. Instead, the auditor must plan to find all misstatements affecting income before taxes that exceed the preliminary judgment about materiality of birr 100,000. Because almost all misstatements affect the income statement and balance sheet, the auditor uses a primary preliminary materiality level of birr 100,000 for most tests. The only other misstatements that will affect current assets are misclassifications within balance sheet accounts, such as misclassifying a long-term asset as a current one. So, in addition to the primary preliminary judgment of materiality of birr 100,000, the auditor will also need to plan the audit with the birr 250,000 preliminary judgment about materiality for misclassifications of current assets.

Qualitative factors also affect materiality: Certain types of misstatements are likely to be more important to users than others, even if the dollar amounts are the same. For example:

- Amounts involving fraud are usually considered more important than unintentional errors of equal dollar amounts because fraud reflects on the honesty and reliability of the management or other personnel involved. For example, most users consider an intentional misstatement of inventory more important than clerical errors in inventory of the same dollar amount.
- Misstatements that are otherwise minor may be material if there are possible consequences arising from contractual obligations. Say that net working capital included in the financial statements is only a few hundred dollars more than the required minimum in a loan agreement.

If the correct net working capital were less than the required minimum, putting the loan in default, the current and noncurrent liability classifications would be materially affected.

- Misstatements that are otherwise immaterial may be material if they affect a trend in earnings. For example, if reported income has increased 3 percent annually for the past 5 years but income for the current year has declined 1 percent, that change may be material. Similarly, a misstatement that would cause a loss to be reported as a profit may be of concern.

Step 2. Allocate preliminary judgment about materiality to segments (tolerable misstatement)

The allocation of the preliminary judgment about materiality to segments is necessary because auditors accumulate evidence by segments rather than for the financial statements as a whole. If auditors have a preliminary judgment about materiality for each segment, it helps them decide the appropriate audit evidence to accumulate. For an accounts receivable balance of birr 1,000,000, for example, the auditor should accumulate more evidence if a misstatement of birr 50,000 is considered material than if birr 300,000 were considered material.

Most practitioners allocate materiality to balance sheet rather than income statement accounts, because most income statement misstatements have an equal effect on the balance sheet due to the nature of double-entry accounting. For example, a birr 20,000 overstatement of accounts receivable is also a birr 20,000 overstatement of sales. It is inappropriate to allocate the preliminary judgment to both income statement and balance sheet accounts because doing so will result in double counting, which will in turn lead to smaller tolerable misstatements than is desirable. This enables auditors to allocate materiality to either income statement or balance sheet accounts. Because there are fewer balance sheet than income statement accounts in most audits, and because most audit procedures focus on balance sheet accounts, materiality should be allocated only to balance sheet accounts. When auditors allocate the preliminary judgment about materiality to account balances, the materiality allocated to any given account balance is referred to as tolerable misstatement. For example, if an auditor decides to allocate birr 100,000 of a total preliminary judgment about materiality of birr 200,000 to accounts receivable, tolerable misstatement for accounts receivable is birr 100,000. This means that the auditor is willing to consider accounts receivable fairly stated if it is misstated by birr 100,000 or less. Auditors face three major difficulties in allocating materiality to balance sheet accounts:

1. Auditors expect certain accounts to have more misstatements than others.
2. Both overstatements and understatements must be considered.

3. Relative audit costs affect the allocation.

All three of these difficulties are considered in the allocation. It is worth keeping in mind that at the end of the audit, the auditor must combine all actual and estimated misstatements and compare them to the preliminary judgment about materiality. In allocating tolerable misstatement, the auditor is attempting to do the audit as efficiently as possible.

Activity



Dear learner! Explain the two steps Auditors follow in applying materiality at the planning phase

3.2 Risk assessment

The second standard of fieldwork requires the auditor to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatements in the client's financial statements. ***Risk, in auditing, is defined as some level of uncertainty that an auditor accepts in performing the audit function.***

Audit Risk Model: The audit risk model is used primary for planning purpose in deciding how much evidence to accumulate in each side. The audit risk model is stated as follows:

$$AAR = PDR \times CR \times IR$$

$$PDR = \frac{AAR}{CR \times IR}$$

Planned detection risk (PDR) is the risk that audit evidence for a segment will fail to detect misstatements exceeding tolerable misstatement. There are two key points to know about planned detection risk. Planned detection risk is dependent on the other three factors in the

1. model. It will change only if the auditor changes one of the other risk model factors. Planned detection risk determines the amount of substantive evidence that the auditor plans to accumulate, inversely with the size of planned detection risk. If planned detection risk is reduced, the auditor

needs to accumulate more evidence to achieve the reduced planned risk. For example, if planned detection risk (D) is low for inventory and warehousing, this causes planned evidence to be high.

2. **Inherent Risk (IR):** **Inherent risk** measures the auditor's assessment of the likelihood that there are material misstatements due to error or fraud in a segment before considering the effectiveness of internal control. If the auditor concludes that a high likelihood of misstatement exists, the auditor will conclude that inherent risk is high. Internal controls are ignored in setting inherent risk because they are considered separately in the audit risk model as control risk. Inherent risk is inversely related to planned detection risk and directly related to evidence. If Inherent risk for inventory and warehousing is high, which results in a lower planned detection risk and more planned evidence than if inherent risk were lower. In addition to increasing audit evidence for a higher inherent risk in a given audit area, auditors commonly assign more experienced staff to that area and review the completed audit tests more thoroughly. For example, if inherent risk for inventory obsolescence is extremely high, it makes sense for the CPA firm to assign an experienced staff person to perform more extensive tests for inventory obsolescence and to more carefully review the audit results.

Factors Affecting Inherent Risk

The auditor must assess the factors that make up the risk and modify audit evidence to take them into consideration. The auditor should consider several major factors when assessing inherent risk:

- Nature of the client's business
- Results of previous audits
- Initial versus repeat engagement
- Related parties
- Non-routine transactions
- Judgment required to correctly record account balances and transactions
- Makeup of the population
- Factors related to fraudulent financial reporting
- Factors related to misappropriation of assets
- **Nature of the Client's Business** Inherent risk for certain accounts is affected by the nature of the client's business. For example, an electronics manufacturer faces a greater likelihood of obsolete inventory than a steel fabricator does. Inherent risk is most likely to vary from business to business for accounts such as inventory, accounts and loans receivable, and property, plant,

and equipment. The nature of the client's business should have little or no effect on inherent risk for accounts such as cash, notes, and mortgages payable. Information gained while obtaining knowledge about the client's business and industry and assessing client business risk.

- **Results of Previous Audits** Misstatements found in the previous year's audit have a high likelihood of occurring again in the current year's audit, because many types of misstatements are systemic in nature, and organizations are often slow in making changes to eliminate them. Therefore, an auditor is negligent if the results of the preceding year's audit are ignored during the development of the current year's audit program. For example, if the auditor found a significant number of misstatements in pricing inventory in last year's audit, the auditor will likely assess inherent risk as high in the current year's audit, and extensive testing will have to be done as a means of determining whether the deficiency in the client's system has been corrected. If, however, the auditor found no misstatements for the past several years in conducting tests of an audit area, the auditor is justified in reducing inherent risk, provided that changes in relevant circumstances have not occurred.
- **Initial Versus Repeat Engagement** Auditors gain experience and knowledge about the likelihood of misstatements after auditing a client for several years. The lack of previous years' audit results causes most auditors to assess a higher inherent risk for initial audits than for repeat engagements in which no material misstatements were previously found. Most auditors set a high inherent risk in the first year of an audit and reduce it in subsequent years as they gain more knowledge about the client.
- **Related Parties** Transactions between parent and subsidiary companies, and those between management and the corporate entity, are examples of related-party transactions as defined by accounting standards. Because these transactions do not occur between two independent parties dealing at "arm's length," a greater likelihood exists that they might be misstated, causing an increase in inherent risk.
- **Nonroutine Transactions:** Transactions that are unusual for a client are more likely to be incorrectly recorded than routine transactions because the client often lacks experience recording them. Examples include fire losses, major property acquisitions, and restructuring charges resulting from discontinued operations. By knowing the client's business and reviewing minutes of meetings, the auditor can assess the consequences of nonroutine transactions.

- **Judgment Required to Correctly Record Account Balances and Transactions** Many account balances such as certain investments recorded at fair value, allowances for uncollectible accounts receivable, obsolete inventory, liability for warranty payments, major repairs versus partial replacement of assets, and bank loan loss reserves require estimates and a great deal of management judgment. Because they require considerable judgment, the likelihood of misstatements increases, and as a result the auditor should increase inherent risk.
- **Makeup of the Population** Often, individual items making up the total population also affect the auditor's expectation of material misstatement. Most auditors use a higher inherent risk for accounts receivable where most accounts are significantly overdue than where most accounts are current. Examples of items requiring a higher inherent risk include transactions with affiliated companies (see vignette below), amounts due from officers, cash disbursements made payable to cash, and accounts receivable outstanding for several months. These situations require greater investigation because of a greater likelihood of misstatement than occurs with more typical transactions.
- **Factors Related to Fraudulent Financial Reporting and Misappropriation of Assets:** It is difficult in concept and practice to separate fraud risk factors into acceptable audit risk, inherent risk, or control risk. For example, management that lacks integrity and is motivated to misstate financial statements is one of the factors in acceptable audit risk, but it may also affect control risk. Similarly, several of the other risk factors influencing management characteristics are a part of the control environment, as we'll discuss in Chapter 10. These include the attitude, actions, and policies that reflect the overall attitudes of top management about integrity, ethical values, and commitment to competence.

- 3. Control Risk (CR):** Control risk measures the auditor's assessment of whether misstatements exceeding a tolerable amount in a segment will be prevented or detected on a timely basis by the client's internal controls. Assume that the auditor concludes that internal controls are completely ineffective to prevent or detect misstatements. The auditor will therefore assign a high, perhaps 100 percent, risk factor to control risk. The more effective the internal controls, the lower the risk factor that can be assigned to control risk.

The audit risk model shows the close relationship between inherent and control risks. For example, an inherent risk of 40 percent and a control risk of 60 percent affect planned detection risk and planned

evidence the same as an inherent risk of 60 percent and a control risk of 40 percent. In both cases, multiplying *IR* by *CR* results in a denominator in the audit risk model of 24 percent. The combination of inherent risk and control risk is referred to in auditing standards as the **risk of material misstatement**.

The auditor may make a combined assessment of the risk of material misstatement or the auditor can separately assess inherent risk and control risk. (Remember, inherent risk is the expectation of misstatements **before** considering the effect of internal control.) As with inherent risk, the relationship between control risk and planned detection risk is inverse, whereas the relationship between control risk and substantive evidence is direct. If the auditor concludes that internal controls are effective, planned detection risk can be increased and evidence therefore decreased. The auditor can increase planned detection risk when controls are effective because effective internal controls reduce the likelihood of misstatements in the financial statements. Before auditors can set control risk less than 100 percent, they must obtain an understanding of internal control, evaluate how well it should function based on the understanding, and test the internal controls for effectiveness. Obtaining an understanding of internal control is required for all audits. The latter two are assessment of control risk steps that are required only when the auditor assesses control risk below maximum.

4. Acceptable Audit Risk (AAR): Acceptable audit risk is a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been issued. When auditors decide on a lower acceptable audit risk, they want to be more certain that the financial statements are **not** materially misstated. Zero risk is certainty, and a 100 percent risk is complete uncertainty. Complete assurance (zero risk) of the accuracy of the financial statements is not economically practical. Moreover, the auditor cannot guarantee the complete absence of material misstatements. Often, auditors refer to the term **audit assurance** (also called **overall assurance or level of assurance**) instead of acceptable audit risk. Audit assurance or any of the equivalent terms is the complement of acceptable audit risk, that is, one minus acceptable audit risk. In other words, acceptable audit risk of 2 percent is the same as audit assurance of 98 percent.

Example: Assume the following risks expected by Mr. A, auditor for XYZ Company and ABC Company respectively.

$$\text{a) } IR = 100\% \quad CR = 100\% \quad AAR = 5\%$$

$$\text{b) IR} = 10\% \quad \text{CR} = 10\% \quad \text{AAR} = 5\%$$

$$\text{a) DR} = \frac{\text{AAR}}{\text{IR} \times \text{CR}} = \frac{5\%}{100\% \times 100\%} = 0.05$$

$$\text{b) DR} = \frac{\text{AAR}}{\text{IR} \times \text{CR}} = \frac{5\%}{10\% \times 10\%} = 5$$

Interpretation:

Mr. A is highly required to accumulate more evidences because the possibility of finding the errors in the financial statement of XYZ Company is lesser as compared to ABC Company's.

Activity

Dear learner! Assume the following risks expected by Mr. M auditor for AB Company IR = 40% CR = 60% AAR = 5%
Calculate planned detection risk?

CHAPTER SUMMARY

This chapter focus on Materiality and risk are fundamental concepts important to audit planning. Both concepts require significant auditor judgment and they directly impact the auditor's planned audit evidence. Materiality is important because the auditor provides assurance to financial statement users that the financial statements are free of material misstatements. Thus, the auditor must develop a preliminary judgment about materiality to be able to design an audit plan that will provide a basis for that assurance. Furthermore, because auditors accept some level of uncertainty in performing the audit function, the consideration of risk as defined by the audit risk model is necessary for the auditor to effectively address those risks in the most appropriate manner. The auditor's understanding of the entity and its environment, including its internal control, provide a basis for the auditor's assessment of the risk of material misstatement. Using the audit risk model and tolerable misstatement for each account, the auditor determines the audit evidence needed to achieve an acceptable level of audit risk for the financial statements as a whole.

SELF TEST QUESTIONS

PART I- MULTIPLE CHOICE QUESTIONS

1. Which one of the following statements is correct concerning the concept of materiality?
 - A. Materiality is determined by reference to guidelines established by the AICPA.
 - B. Materiality depends only on the dollar amount of an item relative to other items in the financial statements.
 - C. Materiality depends on the nature of an item rather than the dollar amount.
 - D. Materiality is a matter of professional judgment.
2. Which of the following is *not* correct about materiality?
 - A. The concept of materiality recognizes that some matters are important for fair presentation of financial statements in conformity with accounting standards, whereas other matters are not important.
 - B. An auditor considers materiality for planning purposes in terms of the largest aggregate level of misstatements that could be considered material to any one of the financial statements.
 - C. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.
 - D. An auditor's consideration of materiality is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.
3. Inherent risk and control risk differ from planned detection risk in that they
 - A. arise from the misapplication of auditing procedures.
 - B. may be assessed in either quantitative or nonquantitative terms.
 - C. exist independently of the financial statement audit.
 - D. can be changed at the auditor's discretion.
4. Which of the following best describes the element of inherent risk that underlies the application of auditing standards?
 - A. Cash audit work may have to be carried out in a more conclusive manner than inventory audit work.
 - B. Intercompany transactions are usually subject to less detailed scrutiny than arm's length transactions with outside parties.

- C. Inventories may require more attention by the auditor on an engagement for a merchandising enterprise than on an engagement for a public utility.
 - D. The scope of the audit need not be expanded if misstatements that arouse suspicion of fraud are of relatively insignificant amounts.
5. Based on evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor could
- A. decrease detection risk.
 - B. increase materiality levels.
 - C. decrease substantive testing.
 - D. increase inherent risk.

PART III. SHORT ANSWER

Give brief and neat answers for the following questions (give further explanation if needed)

1. why Materiality is depending on a relative concept rather than an absolute?

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2. Explain the two phases to determine materiality?

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3. Explain the difference between inherent risk and acceptable audit risk?

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CHAPTER FOUR

INTERNAL CONTROL

4.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- ❖ Explain the meaning and objectives of internal control.
- ❖ Distinguish among the major types and components of an internal control structure.
- ❖ Explain the characteristics of effective internal control.
- ❖ Describe the auditor's consideration of the internal control structure.
- ❖ Discuss the techniques used by auditors to obtain an understanding of internal control.

4.1. INTRODUCTION

Dear learners! In this chapter you will learn about internal control system. Internal control is the tool available for management with the help of which management governs the operations and the policies of the business. The internal controls are exercised to ensure the correctness and fairness of the records, and to strengthen the weaker aspects. Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Understanding client's internal control system is considered the first and the most important activity of the auditor in performing his/her engagement. This chapter has three major objectives, first to explain the meaning and significance of internal control, second, to discuss the major components of a client's internal control structure; and third, to show how auditors go about obtaining an understanding of internal control to meet the requirements of the second standard of field work (i.e. auditors must study and evaluate internal control).

Internal control has attained greatest significance in large-scale business organizations. Accordingly, the greater part of the discussion in this chapter is presented in terms of the large corporation. A separate section is presented at the end of the chapter, however, dealing with internal control in a small business.

4.2. THE MEANING OF INTERNAL CONTROL

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; accuracy, reliability and timely preparation of financial reports; prevention and detection of fraud and error; compliance with internal policies and applicable laws and regulations; and safeguarding of assets against unauthorized acquisition, use or disposition.

Internal control can also be defined as the whole system of controls, financial or any other, established by the management, in order to carry on the business of the company in an orderly manner, safeguard its assets, promote operational efficiency, encourage adherence to prescribed managerial policies and secure the accuracy and reliability of its records. It includes the plans, policies and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of the accounting records and timely preparation of reliable financial information.

The system of internal control extends beyond those matters which relate to the functions of accounting information. Even if the auditors are not responsible for internal control system their understanding will help them in applying different audit tests and checking systems and also in determining the nature, timing and extent of audit procedures to be followed during a given engagement.

Activity

Dear learners! Can you define internal control system using your own words based on what you have studied under lesson 4.2?

4.3. OBJECTIVES OF INTERNAL CONTROL

A system of internal control consists of policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals. These policies and procedures

are often called controls, and collectively, they make up the entity's internal control. Management typically has three broad objectives in designing an effective internal control system

1. **Reliability of financial reporting.** Management is responsible for preparing statements for investors, creditors, and other users. Management has both a legal and professional responsibility to be sure that the information is fairly presented in accordance with reporting requirements of accounting frameworks such as GAAP and IFRS. The objective of effective internal control over financial reporting is to fulfill these financial reporting responsibilities.
2. **Efficiency and effectiveness of operations.** Controls within a company encourage efficient and effective use of its resources to optimize the company's goals. An important objective of these controls is accurate financial and nonfinancial information about the company's operations for decision making.
3. **Compliance with laws and regulations.** Section 404 requires management of all public companies to issue a report about the operating effectiveness of internal control over financial reporting. In addition to the legal provisions of Section 404, public, nonpublic, and not-for-profit organizations are required to follow many laws and regulations. Some relate to accounting only indirectly, such as environmental protection and civil rights laws. Others are closely related to accounting, such as income tax regulations and anti-fraud legal provisions. Management designs systems of internal control to accomplish all three objectives.

The auditor's focus in both the audit of financial statements and the audit of internal controls is on controls over the reliability of financial reporting plus those controls over operations and compliance with laws and regulations that could materially affect financial reporting.

4. **Prevention and detection of fraud and error.** The directors, of the firms under audit, are responsible for taking reasonable steps to prevent and detect fraud. They are also responsible for preparing financial statements, which give a true and fair view of the entity's affairs. However, the auditors must plan and perform their audit procedures, evaluate and report the results thereof; recognizing that fraud or error may materially affect the financial statements. A strong system of internal control will give the auditors some assurance that frauds and errors are not occurring unless management are colluding to override that system.

Activity

Dear learners! Describe the four broad objectives management has when designing effective internal control.

4.4. TYPES OF INTERNAL CONTROL

Controls will enable the entity to manage both operational activities and financial activities within the organization. Organizations should have these two types of controls- administrative controls and accounting controls -each discussed below:

1. **Administrative controls** are primarily concerned with the promotion of operational efficiency and the adherence to prescribed managerial policies. They do not have much bearing on the financial records of the organization and are related to the policies and procedures of decision making in the organization. Administrative controls are related to operational audits and compliance audits.
2. **Accounting controls** are controls which are directly related to the accounting work and principally concerned with safeguarding assets and providing assurance that the financial statements and the underlying accounting records are reliable. Accounting controls are designed to provide reasonable assurance that:
 - i. Transactions are executed in accordance with management's general or specific authorization.
 - ii. Transactions are promptly recorded in the correct amount, in the appropriate accounts and in the accounting period in which they are executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirement and to maintain accountability for assets.
 - iii. Access to assets is permitted only in accordance with management's authorization. Assets are safeguarded from unauthorized access, use or disposition.
 - iv. The recorded accountability of assets is compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Activity

Dear learners! Discuss the two types of internal control

4.5 COMPONENTS OF INTERNAL CONTROL

Internal Control Integrated Framework, the most widely accepted internal control framework in the United States, describes five components of internal control that management designs and implements to provide reasonable assurance that its control objectives will be met. Each component contains many controls, but auditors concentrate on those designed to prevent or detect material misstatements in the financial statements. The internal control components include the following:

- A. Control environment
- B. Risk assessment
- C. Control activities
- D. Information and communication
- E. Monitoring

The control environment serves as the umbrella for the other four components. Without an effective control environment, the other four are unlikely to result in effective internal control, regardless of their quality.

A. The Control Environment

The essence of an effectively controlled organization lies in the attitude of its management. If top management believes that control is important, others in the organization will sense this commitment and respond by conscientiously observing the controls established. If members of the organization believe that control is not an important concern to top management, it is almost certain that management's control objectives will not be effectively achieved. The control environment consists of the actions, policies, and procedures that reflect the overall attitudes of top management, directors, and owners of an entity about internal control and its importance to the entity. To understand and assess the control environment, auditors should consider the most important control subcomponents.

Integrity and Ethical Values Integrity and ethical values are the product of the entity's ethical and behavioral standards, as well as how they are communicated and reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values

and behavioral standards to personnel through policy statements, codes of conduct, and by example.

Commitment to Competence is the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for specific jobs and how those levels translate into requisite skills and knowledge.

Board of Director or Audit Committee Participation The board of directors is essential for effective corporate governance because it has ultimate responsibility to make sure management implements proper internal control and financial reporting processes. An effective board of directors is independent of management, and its members stay involved in and scrutinize management's activities. Although the board delegates responsibility for internal control to management, it must regularly assess these controls. In addition, an active and objective board can reduce the likelihood that management overrides existing controls.

To assist the board in its oversight, the board creates an audit committee that is charged with oversight responsibility for financial reporting. The audit committee is also responsible for maintaining ongoing communication with both external and internal auditors, including the approval of audit and non-audit services done by auditors for public companies. This allows the auditors and directors to discuss matters that might relate to such things as management integrity or the appropriateness of actions taken by management.

The audit committee's independence from management and knowledge of financial reporting issues are important determinants of its ability to effectively evaluate internal controls and financial statements prepared by management. Many privately held companies also create an effective audit committee. For other privately held companies, governance may be provided by owners, partners, trustees, or a committee of management, such as finance or budget committee. Individuals responsible for overseeing the strategic direction of the entity and the accountability of the entity, including financial reporting and disclosure, are called those charged with governance by auditing standards.

Management's Philosophy and Operating Style Management, through its activities, provides clear signals to employees about the importance of internal control. For example, does management take significant risks, or is it risk averse? Are sales and earnings targets unrealistic? And are employees encouraged to take aggressive actions to meet those targets? Can management be described as “fat and bureaucratic,” “lean and mean,” Dominated by one or a few individuals, or is it “just right”? Understanding these and similar aspects of management's philosophy and operating style gives the auditor a sense of management's attitude about internal control.

Organizational Structure The entity's organizational structure defines the existing lines of responsibility and authority. By understanding the client's organizational structure, the auditor can learn the management and functional elements of the business and perceive how controls are implemented.

Human Resource Policies and Practices The most important aspect of internal control is personnel. If employees are competent and trustworthy, other controls can be absent, and reliable financial statements will still result. Incompetent or dishonest people can reduce the system to a shambles—even if there are numerous controls in place. Honest, efficient people are able to perform at a high level even when there are few other controls to support them. However, even competent and trustworthy people can have shortcomings. For example, they can become bored or dissatisfied, personal problems can disrupt their performance, or their goals may change. Because of the importance of competent, trustworthy personnel in providing effective control, the methods by which persons are hired, evaluated, trained, promoted, and compensated are an important part of internal control. After obtaining information about each of the subcomponents of the control environment, the auditor uses this understanding as a basis for assessing management's and directors' attitudes and awareness about the importance of control. For example, the auditor might determine the nature of a client's budgeting system as a part of understanding the design of the control environment. The operation of the budgeting system might then be evaluated in part by inquiry of budgeting personnel to determine budgeting procedures and follow-up of differences between budget and actual.

B. Risk Assessment

Risk assessment for financial reporting is management's identification and analysis of risks relevant to the preparation of financial statements in conformity with appropriate accounting standards. For example, if a company frequently sells products at a price below inventory cost because of rapid technology changes, it is essential for the company to incorporate adequate controls to address the risk of overstating inventory.

Similarly, failure to meet prior objectives, quality of personnel, and geographic dispersion of company operations, significance and complexity of core business processes, introduction of new information technologies, economic downturns, and entrance of new competitors are examples of factors that may lead to increased risk. Once management identifies a risk, it estimates the significance of that risk, assesses the likelihood of the risk occurring, and develops specific actions that need to be taken to reduce the risk to an acceptable level.

Management's risk assessment differs from but is closely related to the auditor's risk assessment. While management assesses risks as a part of designing and operating internal controls to minimize errors and fraud, auditors assess risks to decide the evidence needed in the audit. If management effectively assesses and responds to risks, the auditor will typically accumulate less evidence than when management fails to identify or respond to significant risks. Auditors obtain knowledge about management's risk assessment process using questionnaires and discussions with management to determine how management identifies risks relevant to financial reporting, evaluates the significance and likelihood of the risks occurring, and decides the actions needed to address the risks.

C. Control Activities

Control activities are the policies and procedures, in addition to those included in the other four control components that help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives. There are potentially many such control activities in any entity, including both manual and automated controls. The control activities generally fall into the following five types, which are discussed next:

1. Adequate separation of duties
2. Proper authorization of transactions and activities
3. Adequate documents and records
4. Physical control over assets and records

5. Independent checks on performance

- 1. Adequate Separation of Duties:** Four general guidelines for adequate separation of duties to prevent both fraud and errors are especially significant for auditors.

Separation of the Custody of Assets from accounting to protect a company from embezzlement, a person who has temporary or permanent custody of an asset should not account for that asset. Allowing one person to perform both functions increases the risk of that person disposing of the asset for personal gain and adjusting the records to cover up the theft. If the cashier, for example, receives cash and is responsible for data entry for cash receipts and sales, that person could pocket the cash received and adjust the customer's account by failing to record a sale or by recording a fictitious credit to the account.

Separation of the Authorization of Transactions from the Custody of Related Assets It is desirable to prevent persons who authorize transactions from having control over the related asset, to reduce the likelihood of embezzlement. For example, the same person should not authorize the payment of a vendor's invoice and also approve the disbursement of funds to pay the bill.

Separation of Operational Responsibility from Record-Keeping Responsibility to ensure unbiased information, record keeping is typically the responsibility of a separate department reporting to the controller. For example, if a department or division oversees the creation of its own records and reports, it might change the results to improve its reported performance.

Separation of IT Duties from User Departments As the level of complexity of IT systems increases, the separation of authorization, record keeping, and custody often becomes blurred. For example, sales agents may enter customer orders online. The computer authorizes those sales based on its comparison of customer credit limits to the master file and posts all approved sales in the sales cycle journals. Therefore, the computer plays a significant role in the authorization and record keeping of sales transactions. To compensate for these potential overlaps of duties, it is important for companies to separate major IT-related functions from key user department functions. In this example, responsibility for designing and controlling accounting software programs that contain the sales authorization and posting controls should be under the authority of IT, whereas the ability to update information in the master file of customer credit limits should reside in the company's credit department outside the IT function.

- 2. Proper Authorization of Transactions and Activities:** every transaction must be properly authorized if controls are to be satisfactory. If any person in an organization could acquire or expend assets at will, complete chaos would result. Authorization can be either general or specific. Under general authorization, management establishes policies and subordinates are instructed to implement these general authorizations by approving all transactions within the limits set by the policy. General authorization decisions include the issuance of fixed price lists for the sale of products, credit limits for customers, and fixed reorder points for making acquisitions. Specific authorization applies to individual transactions. For certain transactions, management prefers to authorize each transaction. An example is the authorization of a sales transaction by the sales manager for a used-car company.

The distinction between authorization and approval is also important. Authorization is a policy decision for either a general class of transactions or specific transactions. Approval is the implementation of management's general authorization decisions. An example of a general authorization is management setting a policy authorizing the ordering of inventory when less than a 3-week supply is on hand. When a department orders inventory, the clerk responsible for maintaining the perpetual record approves the order to indicate that the authorization policy has been met.

In other cases, the computer approves the transactions by comparing quantities of inventory on hand to a master file of reorder points and automatically submits purchase orders to authorized suppliers in the vendor master file. In this case, the computer is performing the approval function using preauthorized information contained in the master files.

- 3. Adequate Documents and Records:** Documents and records are the records upon which transactions are entered and summarized. They include such diverse items as sales invoices, purchase orders, subsidiary records, sales journals, and employee time cards. Many of these documents and records are maintained in electronic rather than paper formats. Adequate documents are essential for correct recording of transactions and control of assets. For example, if the receiving department completes an electronic receiving report when material is received, the accounts payable computer application can verify the quantity and description on the vendor's invoice by comparing it with the information on the receiving report, with exceptions resolved by the accounts payable department.

Certain principles dictate the proper design and use of documents and records. Documents and records should be:

Pre-numbered consecutively to facilitate control over missing documents and records and as an aid in locating them when they are needed at a later date. Pre numbered documents and records are important for the completeness transaction-related audit objective.

Prepared at the time a transaction takes place, or as soon as possible thereafter, to minimize timing errors.

Designed for multiple use, when possible, to minimize the number of different forms. For example, a properly designed electronic shipping record can be the basis for releasing goods from storage to the shipping department, informing billing of the quantity of goods to bill to the customer and the appropriate billing date, and updating the perpetual inventory records.

Constructed in a manner that encourages correct preparation. This can be done by providing internal checks within the form or record. For example, computer screen prompts may force online data entry of critical information before the record is electronically routed for authorizations and approvals. Similarly, screen controls can validate the information entered, such as when an invalid general ledger account number is automatically rejected when the account number does not match the chart of accounts master file.

A control closely related to documents and records is the chart of accounts, which classifies transactions into individual balance sheet and income statement accounts. The chart of accounts is helpful in preventing classification errors if it accurately describes which type of transactions should be in each account.

- 4. Physical Control over Assets and Records:** to maintain adequate internal control, assets and records must be protected. If assets are left unprotected, they can be stolen. If records are not adequately protected, they can be stolen, damaged, altered, or lost, which can seriously disrupt the accounting process and business operations.

When a company is highly computerized, its computer equipment, programs, and data files must be protected. The data files are the records of the company and, if damaged, could be costly or even impossible to reconstruct. The most important type of protective measure for safeguarding assets and records is the use of physical precautions. An example is the use of storerooms for inventory to guard against theft. When the storeroom is under the control of a competent employee, there is further assurance that theft is minimized. Fire proof safes and safety deposit vaults for the protection of assets such as currency and securities are other important physical safeguards in addition to off-site back-up of computer software and data files.

- 5. Independent Checks on Performance:** The last category of control activities is the careful and continuous review of the other four, often called independent checks or internal verification. The need for independent checks arises because internal controls tend to change over time, unless there is frequent review. Personnel are likely to forget or intentionally fail to follow procedures, or they may become careless unless someone observes and evaluates their performance. Regardless of the quality of the controls, personnel can make errors or commit fraud.

Personnel responsible for performing internal verification procedures must be independent of those originally responsible for preparing the data. The least expensive means of internal verification is the separation of duties in the manner previously discussed. For example, when the bank reconciliation is done by a person independent of the accounting records and handling of cash, there is an opportunity for verification without incurring significant additional costs.

Computerized accounting systems can be designed so that many internal verification procedures can be automated as part of the system. For example, the computer can prevent processing payment on a vendor invoice if there is no matching purchase order number or receiving report number for that invoice included in the system.

Auditing standards require the auditor to obtain an understanding of the process company employees follow to reconcile detail records supporting a significant account balance to the general ledger for those accounts to help the auditor more effectively design and perform audit procedures. For example, an auditor is likely to send confirmations of customer accounts

receivable selected from accounts receivable master files. Before planning the confirmation procedures the auditor needs to understand the design and implementation of controls that company personnel use to reconcile the accounts receivable master file to the related general ledger account balance.

D. Information and Communication

The purpose of an entity's accounting information and communication system is to initiate, record, process, and report the entity's transactions and to maintain accountability for the related assets. An accounting information and communication system has several subcomponents, typically made up of classes of transactions such as sales, sales returns, cash receipts, acquisitions, and so on. For example, the sales accounting system should be designed to ensure that all shipments of goods are correctly recorded as sales (completeness and accuracy objectives) and are reflected in the financial statements in the proper period (timing objective). The system must also avoid duplicate recording of sales and recording a sale if a shipment did not occur (occurrence objective). To understand the design of the accounting information system, the auditor determines:

1. The major classes of transactions of the entity;
2. How those transactions are initiated and recorded;
3. What accounting records exist and their nature;
4. How the system captures other events that are significant to the financial statements, such as declines in asset values; and
5. The nature and details of the financial reporting process followed, including procedures to enter transactions and adjustments in the general ledger.

E. Monitoring

Monitoring activities deal with ongoing or periodic assessment of the quality of internal control by management to determine that controls are operating as intended and that they are modified as appropriate for changes in conditions. The information being assessed comes from a variety of sources, including studies of existing internal controls, internal auditor reports, exception reporting on control activities, reports by regulators such as bank regulatory agencies, feedback from operating personnel, and complaints from customers about billing charges.

For many companies, especially larger ones, an internal audit department is essential for effective monitoring of the operating performance of internal controls. To be effective, the internal audit function must be performed by staff independent of both the operating and accounting departments and report directly to a high level of authority within the organization, either top management or the audit committee of the board of directors.

In addition to its role in monitoring an entity's internal control, an adequate internal audit staff can reduce external audit costs by providing direct assistance to the external auditor. PCAOB Standard 5 defines the extent that auditors can use the work done by internal auditors when reporting on internal control under Section 404. Auditing standards provide guidance to help the external auditor obtain evidence that supports the competence, integrity, and objectivity of internal auditors, which allows the external auditor to rely on the internal auditor's work in a number of ways.

Certain control elements within the five COSO control components have a pervasive effect on the entity's system of internal control, and are referred to as entity-level controls in PCAOB auditing standards. Examples include the board and audit committee element of the control environment, the entity's risk assessment process, and internal audit's role in monitoring controls.

Activity

Dear learners! What is meant by the control environment? What are the factors the auditor must evaluate to understand it?

What is the relationship among the five components of internal control?

4.6 THE USE OF INTERNAL CONTROL SYSTEMS BY AUDITORS

The auditors shall assess the adequacy of the systems as a basis for the financial statements and shall identify risks of material misstatements to provide a basis for designing and performing further audit procedures. Auditors are only concerned with assessing policies and procedures which are relevant to the financial statements. Auditors shall:

- ✓ Assess the adequacy of the accounting system as a basis for preparing the account
- ✓ Identify the types of potential misstatements that could occur in the accounts
- ✓ Consider factors that affect the risk of misstatements
- ✓ Design appropriate audit procedures

The assessment of the controls of an entity will have an impact on that risk assessment. Risks arising from poor control environments are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited, that is, if control risk is so high that audit risk cannot be Reduced to an acceptable level.

On the other hand, some control procedures may be closely connected to an assertion in financial statements, for example, controls over the inventory count are closely connected with the existence and completeness of inventory in the financial statements. There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall evaluate the design and determine the implementation of the controls that is by controls testing. This is most likely to be the case in a system which is highly computerized and which does not require much manual intervention.

4.7 OBTAIN AND DOCUMENT UNDERSTANDING OF INTERNAL CONTROL

Auditing standards require auditors to obtain and document their understanding of internal control for every audit. This understanding is necessary for both the audit of internal controls over financial reporting and the audit of financial statements. Management's documentation is a major source of information in gaining the understanding. As part of the auditor's risk assessment procedures, the auditor uses procedures to obtain an understanding, which involve

CHAPTER SUMMARY

This chapter focused on management's and the auditor's responsibility for understanding, evaluating, and testing internal control for an integrated audit of financial statements and internal control over financial reporting. To rely on a client's internal controls to report on internal control over financial reporting and to reduce planned audit evidence for audits of financial statements, the auditor must first obtain an understanding of each of the five components of internal control. Knowledge about the design of the client's control environment, risk assessment, control activities, information and communication, and monitoring activities and information about whether internal control components have been implemented assist the auditor in assessing control risk for each transaction-related audit objective.

The auditors assess control risk for each major financial statement assertion to determine the nature, timing, and extent of the substantive tests of the assertion. If the auditors assess control risk below the maximum, they must perform tests of control to determine that the related controls are operating effectively. Tests of control consist of inquiries of appropriate client personnel, inspection of documents and reports, observation of the application of controls, and re performance of controls. In small businesses auditors must rely much more on substantive tests of account balances and transactions rather than tests of controls.

SELF TEST QUESTIONS

Part I. TRUE OR FALSE

Say “True” if the statement is correct and “False” if the statement is incorrect!

1. Management is responsible for preparing statements for investors, creditors, and other users.
2. A company should develop internal controls that provide reasonable, but not absolute, assurance that the financial statements are fairly stated.
3. The auditor obtains the understanding of internal control to assess control risk in every audit.
4. Financial statements are not likely to correctly reflect GAAP or IFRS if internal controls over financial reporting are inadequate.
5. Unlike the client, the auditor is less concerned with controls that affect the efficiency and effectiveness of company operations.

PART II: FILL THE BLANK SPACE

Fill the blank space using the correct word!

1. An act of two or more employees who conspire to steal assets or misstate records is called _____.
2. _____ and _____ are the two key aspects of management’s assessment of internal control over financial reporting.
3. _____ consists of the actions, policies, and procedures that reflect the overall attitudes of top management, directors, and owners of an entity about internal control and its importance to the entity.
4. _____ audit procedures to test the operating effectiveness of controls in support of reduced assessed control risk.
5. _____ management’s ongoing and periodic assessment of the quality of internal control performance to determine that controls are operating as intended and are modified when needed.

PART III. SHORT ANSWER

Give brief and neat answers for the following questions (give further explanation if needed)

1. What is an internal control?

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2. Define the control environment?

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3. What are the major objectives of internal control?

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4. What are the elements of internal control?

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5. Which auditing standard states about the auditor's consideration of internal control?

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6. Why must auditors obtain an understanding of the client's accounting system?

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CHAPTER FIVE

AUDIT EVIDENCE

5.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

-  Specify the characteristics that determine the persuasiveness of audit evidence.
-  Identify and apply the types of evidence used in auditing.
-  Explain the purposes of audit documentation.
-  Prepare organized audit documentation

5.1 INTRODUCTION

The auditors must gather sufficient competent evidence to provide an adequate basis for their opinion on the financial statements. Sufficient evidential matter is a measure of the quantity of the evidence required whereas the competency of evidential matter relates to its quality. The requirement to obtain sufficient competent evidence is reflected in the third standard of field work as:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under audit.

The auditors should document the evidence they have obtained. Papers that document the evidence gathered by the auditors to show the work they have done, the methods and procedures they have followed, and the conclusions they have developed are called working papers.

5.2 AUDIT EVIDENCE

The term “audit evidence” in this context refers to information obtained by the auditor in arriving at reasonable conclusions on which he/she bases his/her opinion on the financial statements. Sources of such audit evidence include the accounting system and underlying documentation of entity, its tangible assets, its management and employees, its customers, its suppliers, and other third parties who have dealings with, or knowledge, of the entity or its activities.

Auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. Audit evidence can be obtained in many ways, often with a mix of tests of controls and substantive procedures, although sometimes only substantive procedures will be used along with requires as to the adequacy of the accounting system as a basis for the preparation of the financial statements.

There is an inverse relationship between the quantity of audit evidence that is sufficient in specific situation and the competence of that evidence. More competent evidential matter leads to a decrease in the amount of evidence that is needed to support the auditor's opinion. Also, several pieces of related evidence may form a package of evidence that has greater competence than do the pieces when viewed individually. To be competent, evidence must be relevant, reliable and valid. For evidence to be relevant it must relate to the audit objective being tested. The reliability of audit evidence is influenced by its source (internal or external) and by its nature (visual, documentary or oral). The following generations may help in assessing the reliability of evidence;

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

The validity of evidence is dependent on the circumstances in which it is obtained. The following factors generally affect the validity of evidential matter:

- When auditors obtain evidence from independent sources outside of the client company, it provides greater assurance of reliability than that secured solely within the company.
- The more effective the internal control, the greater reliability of the accounting records and other internally generated documents.
- Evidence obtained directly by the auditors through physical examination, observation,

computation, and inspection is more persuasive than information obtained indirectly, or secondhand.



In addition, the competence of particular evidence matter is enhanced when the auditors are able to obtain evidence that confirms the original evidence.

Consistency of audit evidence from different sources will have a corroborating effect, making the evidence more persuasive. Where such evidence is inconsistent, the auditors must determine what additional procedures are necessary to resolve the inconsistency. Auditors must consider the cost-benefit relationship of obtaining evidence but any difficulty or expense is not in itself a valid basis for omitting a necessary procedure.

5.2.1 SUFFICIENT APPROPRIATE AUDIT EVIDENCE

Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency implies the measure of the quantity of audit evidence obtained; appropriateness implies the relevance and reliability of audit evidence.

Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. It may become necessary for him to obtain evidence from different sources or of a different nature in support of the same assertion or conclusion. The audit evidence should in total enable the auditor to form an opinion on the financial statements. In forming such an opinion, it is neither feasible nor possible for an auditor to examine each and every item of the information available to him. The usual procedure is to select a few representative items or transactions or events. Here the auditor will have to exercise his professional judgment after a careful study of the circumstances in the particular case in deciding as to what may be considered as sufficient appropriate audit evidence necessary to achieve the required level of assurance.

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

- 1) The auditor's knowledge of the business of the client organization and the industry in which it operates.
- 2) The degree of risk of misstatement through errors or irregularities. This risk, in turn, maybe affected by – the nature of the item, the adequacy of internal control, the nature of the business carried on by the client organization, situations which may exercise an unusual pressure on the management including possible management bias, the financial position of the client organization.

- 3) The materiality of the item in relation to the financial statements taken as a whole.
- 4) The experience gained during the previous audits as to the reliability of the management and staff of the client organization and of its records.
- 5) The extent of irregularities revealed during the course of performing audit procedures including fraud or error which may have been found, and
- 6) Material variances in comparative figures of working ratios for the previous years or for similar organization in the same industry.

Auditors are essentially looking for enough reliable audit evidence. Audit evidence usually indicates what is probable rather than what is definite (is usually persuasive rather than conclusive). Hence, auditors cannot give absolute but only reasonable assurance that the financial statements are free from misstatement.

5.2.2 OBTAINING AUDIT EVIDENCE FROM TESTS OF CONTROLS

In seeking to obtain audit evidence from tests of control, auditors should consider the sufficiency and appropriateness of the audit evidence to support the assessed level of controls risk. There are two aspects of the relevant parts of the accounting and internal control systems about which auditor should seek to obtain audit evidence.

- a) Design: Are the accounting and internal control systems capable of preventing or detecting material misstatements?
- b) Operation: Is the system exists and has operated effectively throughout the period under consideration?

5.2.3 OBTAINING AUDIT EVIDENCE FROM SUBSTANTIVE PROCEDURES

In seeking to obtain audit evidence from substantive procedures, auditors should consider the extent to which that evidence together with any evidence from test of control supports the relevant financial statement assertions. Substantive procedures are designed to support the financial statement assertions.

Financial statement assertions are the representations of the directors that are embodied in the financial statements. By approving the financial statements, the directors are making representations about the information therein. These representatives or assertions may be described in general terms in a number of ways, like the following;

- Existence: an asset or liability exists at a given date.
- Right and obligations: an asset or liability pertains to the entity at a given date.

- Occurrence: a transaction or event took place which pertains to the entity during the relevant period.
- Completeness: there are no unrecorded assets, liabilities, transactions or events or undisclosed items.
- Valuation: an asset or liability is recorded at an appropriate value.
- Measurement: a transaction or even is recorded in the proper amount and revenue or expense is allocated to the proper period.
- Presentation and disclosure: an item is disclosed, classified and described in accordance with the applicable reporting framework. (eg. relevant legislation and applicable accounting standards).

Audit evidence: is usually obtained to support each financial statement assertion and evidence from one does not compensate for failure to obtain evidence from another. However, tests may provide audit evidence of more than one assertion.

Where tests of control provide satisfactory evidence as to the effectiveness of accounting and internal control system, the extent of relevant substantive procedures may be reduced, but not entirely eliminated. Substantive procedures may also be incorporated within other procedures such as test of control.

5.3 EVIDENCE GATHERING TECHNIQUES

Audit evidence is obtained through one or more of the following techniques of audit testing listed below. The timing of performing them will be dependent, in part, upon the period of the time during which the audit evidence sought is available.

A. Inspection

Inspection consists of reviewing or examining records and documents, or physical verification of tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature and source, and the effectiveness of internal controls over their processing. Inspecting of tangible assets provides reliable audit evidence about their existence but not necessary as to their ownership or value. The assets' appearance may indicate they are obsolete, but more work will be required to confirm exact valuation.

Inspection is an important test of control in that it can be used to test whether documents such as invoices have been properly authorized. It can also highlight whether a transaction in the accounting records does not relate to the client, for example a transaction supported by an invoice which is not addressed to the client. There are several techniques to be used in inspecting documents, some of them {vouching, tracing and scanning/reading) are explained below:

Vouching:

Vouching is a technique which starts with the record, e.g., a general ledger posting, or a general ledger balance (underlying accounting data), and then examines the supporting documents (invoices, vouchers, cash receipts) that corroborate the figures. For example, invoices for all additions to plant assets might be vouched, to determine that all plant asset additions were purchased and not leased. If the balances or transactions are corroborated by valid supporting documents, then the evidence suggests that the existence or occurrence assertion is appropriate. Vouching is used if overstatement is most likely, i.e. for assets or revenues.

Tracing:

Tracing, unlike vouching, is used if understatement is most likely, i.e. for liabilities or expenses. Tracing starts with the supporting documents and traces the amounts on them to the journal or ledger (underlying accounting data). A common tracing procedure might call for drawing a sample of cash payments which are then traced to the expense accounts to which they were debited to ensure that all were properly charged. If all expenses are charged correctly, then the evidence suggests that the completeness assertion is proper.

Scanning or Reading:

This is another type of documentary inspection. Scanning means to look at quickly. Reading is done with more care. Reading of course takes more time, so the auditor should scan documents first; then decide which ones deserve a more careful reading. Particular documents that should be read or scanned by the auditor include:

- *The working trial balance and some selected accounts, especially those that are material or have lots of activity.* When an account or the trial balance is scanned, large or unusual amounts are expected to come to the auditor's attention. These will merit further investigation.
- *The Minutes of Board Meetings:* In general, the auditor should be alert to any financial matters that might materially impact the financial statements. Special consideration is to be given to business decisions, such as the addition of a new department or product line, or authorization of the purchase or disposal of fixed assets. Other items of interest include discussions of matters that might imperil

(put in danger) the going concern of the entity, such as contingent liabilities. The auditor might also note controls that have been implemented or emphasized, so that compliance with those control might be verified.

- *Notes and Bonds Payables Documents:* The auditor will want to identify the interest rate which is being charged, and any restrictions which the creditors place on the client's operations. Going concern issues are also considered in inspecting notes and bonds payables.
- *Employee and Procedure Manuals:* How are employees selected, supervised and evaluated? Is there a code of conduct? What are related important control procedures which have been established? The auditor may need to read /scan documents in order to answer these and other related questions.
- *Contracts:* With whom does the entity do business? Is there evidence of contingent liabilities in the contracts, such as penalties for missing a completion of deadline? Do the contracts raise questions about going concern? Are contracts fulfilled conscientiously (carefully)? Are the contracts for fixed asset leases rather than purchases? Answers to these and other related questions may give an insight to the auditor on potential departure from GAAP and on the integrity and ethical values of the client.
- *Correspondence:* Special attention should be paid to correspondence (obtaining information from third parties) regarding disputed/doubtful receivables, as this may give clues to possible mishandling of cash payments. Also of interest is correspondence from creditors, as this may reveal going concern problems.

B. Observation

This consists at looking at an operation or process or a procedure being performed by others with a view to determining the manner of its performance. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures. It may be noted in this connection that "observation" provides reliable evidence as to the manner of the performance at the time of observation, but not any other time. In addition, in some ways observation gives limited assurance since it only provides evidence of how the procedure was performed when the auditor was watching client staff may have been on their best behavior on that occasion and be less conscientious of other items.

C. Enquiry

Enquiry consists of seeking relevant information from knowledgeable persons inside or outside the entity. Enquiries may be formal or informal, written or oral. In other words, they range from formal written enquiries addressed to persons outside the entity to oral enquiries addressed to persons within the entity. Response to enquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence. The strength of the evidence depends on the knowledge and integrity of the source.

D. Confirmation

Confirmation consists of the response to an enquiry to corroborate information contained in the accounting records. For instance, it is a normal auditing procedure to request confirmation of bank balances, debtor balances, etc by direct communication with the bank, debtors etc.

An auditor can have strong evidence if an independent party makes a written or oral statement in support of certain facts if the auditor is of the opinion that the party has the necessary competence, experience and integrity. Statement from the bank as to bank balances, statements from the client's lawyers as to the extent of contingent liabilities in respect of disputed claims before courts of law, etc. are some examples.

In the absence of suspicious circumstances, an auditor can place limited reliance on the statements by officers and employees of the entity. During the course of audit, an auditor often requires the officers and other employees to provide him with detailed explanations and information. Such statements may be formal or informal. While this evidence is not sufficient in it self and cannot be considered as reliable as statements from independent third parties, it is a valuable form of corroborative evidence. In addition, it may disclose situation that require further investigation. Also, some explanations and affirmation can be provided only by the officers and employees of the entity.

E. Computation

This consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations. Independent computations made by the auditor often provide an important source of audit evidence. Examples of computations include the adding up of bank reconciliation or ledger accounts, calculating the balance of interest expense or interest income, calculating depreciation expense and etc.

F. Analytical Review Procedures

Analytical review procedures involve evaluations of financial statement information by a study of relationships among financial and non-financial data. This consists of studying significant ratios, trends and other statistics and investigating unusual or unexpected fluctuations and items, and expected

fluctuations which fail to occur. Auditors use technique to obtain evidence about reasonableness of financial statement amounts. Analytical procedures range from simple techniques, like comparing current year sales amounts with the previous year, to more sophisticated techniques, like multiple regression model.

Analytical review procedures are the analysis of relationships

- i) Between items of financial data, or between items of financial and non-financial data, deriving from the same period; or
- ii) Between comparable information deriving from different periods to identify consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigation thereof.

Various types of ratios, changes and trends analyses have become recognized in recent years as important audit tools. Whether the data meet the test of logic, reasonableness and normality is just significant.

5.4 TYPES OF AUDIT EVIDENCE

The auditors gather a combination of many types of audit evidence to adequately restrict audit risk. The major types of audit evidence may be summarized as follows:

1. Physical evidence

Evidence that the auditors can actually see is referred to as physical evidence. As an example, the best evidence of the existence of certain assets is the auditors' examination of the assets themselves. The existence of property and equipment, such as automobiles, building, office equipment, and factory machinery, may be conclusively established by physical examination. Similarly, evidence about the existence of cash may be obtained by counting, and the client's inventory may be observed as it is counted by client personnel. The auditors also can determine whether an internal control activity is being performed by observing the employees performing the activity.

2. Third party representations

Auditors obtain a variety of representations from a number of outside parties, such as the client's customers, vendors, financial institutions, and attorneys. In addition, evidence may be obtained from specialists in some audits.

3. Documentary Evidence

Documentary evidence includes checks, invoices, contracts and minutes of meetings. The competence of a document as evidence depends on whether it was created within the company (e.g., a sales invoice) or outside the company (e.g., a vendor's invoice). Documents created outside the client organization are more competent than those created by the client. Some documents created within the company (e.g., checks) are sent outside the organization for endorsement and processed; because of this critical review by outsiders, these documents are regarded as very reliable evidence.

4. Computations

Another type of audit evidence consists of the results of computations made independently by the auditors to prove the arithmetical accuracy of the client's analyses and records. In its simplest form, an auditor's computations might consist of footing a column of figures in a sales journal or in a ledger account to provide that column total. Independent computations maybe used to prove the accuracy of such client calculations as earnings per share, depreciation expense, allowance for uncollectible accounts, revenue recognized on a percentage of completion basis, and provisions for federal and state income taxes. Specialists may become involved in certain computations. For example, because the computations of a client's liability for postretirement benefits involves actuarial assumptions and are beyond the auditors area of expertise, auditors usually rely on the services of an actuary to compute this liability.

5. Data interrelationships

Data interrelationships involve the comparison of relationships among financial and, sometimes, non financial data. Data interrelationships differ from computations. As indicated in the preceding section, computations verify mathematical processes. Data interrelationships rely upon plausible relationships among both financial and non financial data. For example, a plausible relationship may exist in an industry between annual square footage of sales space and retail sales.

6. Oral and written client representations

Throughout an audit the auditors ask a great many questions of the officers and employees of the client's organization. These questions cover an endless range of topics like the location of records and documents, the reasons underlying an unusual accounting procedure, the probabilities of collecting a long past-due account receivable and so on.

The answers that the auditors receive to these questions constitute another type of evidence. Generally, oral client representations are not sufficient in them selves, but may be useful in disclosing situations that

require investigation or in corroborating other forms of evidence. For example, after making a careful analysis of all past due accounts receivable, an auditor will normally discuss with the credit manager the prospects of collecting specific accounts. If the opinion of the credit manager are in accordance with the estimates of uncollectible accounts that have been made independently by the auditor, this oral evidence will constitute support for the conclusions reached. In audits made for second time or more, the auditor will be in a better position to evaluate the opinions of the credit manager based on the manager's estimates in prior years.

Auditors also obtain written representations from client. At the conclusion of the audit, the auditors obtain from the client a written representations letter summarizing the most important oral representations made by management during the engagement. Many specific items are included in this representation letter. For example, management usually represents that all liabilities known to exist are reflected in the financial statements.

7. Accounting records

When auditors attempt to verify an amount in the financial statements by tracing it back through the accounting records they will ordinarily carry this process through the ledgers to the journal and compare the item to such basic documentary evidence as a paid check, invoice or other source documents. To some extent, however the ledger account and the journals constitute worthwhile evidence in themselves. In addition to journals and ledgers, other accounting records providing evidential matter for auditors' include sales summaries, trial balances, interim financial statements, and operating and financial reports prepared for management.

5.1.EVIDENCE ABOUT ACCOUNTING ESTIMATES

The auditors must be especially careful in considering financial statement accounts that are affected by estimates made by management (often referred to an accounting estimate) particularly those for which a wide range of accounting methods are considered acceptable. Examples of accounting estimates include allowances for loan losses and obsolete inventory, and estimates of warranty liabilities. Making accounting estimates is management's responsibility, and such estimates are generally more susceptible to material misstatement than financial statement amounts, which are more certain in amount.

Standard of auditing requires the auditors to determine that;

- a) All necessary estimates have been developed
- b) The accounting estimates are reasonable, and
- c) The accounting estimates are properly accounted for and disclosed.

Determining whether all necessary estimates have been developed and accounted for properly requires knowledge of the client's business and the applicable generally accepted accounting principles. When evaluating the reasonableness of accounting estimates, the auditors may use one or more of the following three basic approaches:

1. Reviewing and testing management's process of developing the estimates – this will often involve evaluating the reasonableness of the steps performed by management.
2. Independently developing an estimate of the amount to compare to management's estimate.
3. Reviewing subsequent events or transactions bearing on the estimate, such as actual payments of an estimated amount made subsequent to year-end.

5.2.Documenting Audit Evidences

All audit work must be documented; the working papers are the tangible evidence of the work done in support of the audit opinion. Auditor should document in their working papers matters which are important in supporting their report.

Working papers are the materials which the auditors prepare or obtain, and retain in connection with the performance of the audit. Working papers may be in the form of data stored on paper, firm, electronic media or other media. Some working papers take the form of bank reconciliations or analyses of ledger accounts; others may consist of photocopies of minutes of directors' meetings; still others might be organization charts or flowcharts of the client's internal control working trial balance, audit programs, internal control questionnaires, letters of representation obtained from the client and from the client's legal counsel, returned confirmation forms – all of these schedules lists, notes and documents are part of the auditors' working papers.

Thus, the term audit working papers is quite comprehensive. Remember that the partner who signs the auditors' report did not personally perform most of the audit procedures. For example, in case of the office of the federal auditor general of Ethiopia, the audit report is signed by the auditor general or the vice but the actual field work is performed by auditors at a position of supervisor or below. The partner's

opinion was developed primarily by reviewing the working papers prepared by the audit staff. Therefore, the working papers must include adequate support for expressing an opinion on the fairness of the client's financial statements.

Working papers support, among other things, the statement in the auditors' report as to the auditors' compliance or otherwise with auditing standards to the extent that this is important in supporting their report. Working Papers are the connecting link between the client's accounting records and the auditors' report. They document all of the work performed by the auditors and provide the justification for the auditors' report. The sufficient, competent evidential matter required by the third field work standard must be clearly documented in the auditors' working papers.

Working papers are records of:

- a) the planning and performance of the audit
- b) the supervision and review of the audit work; and
- c) the audit evidence resulting from the audit work performed which the auditors consider necessary and on which they have relied to support their report.

No one standard set of working papers is suitable for all engagements. As auditors move from one client to another, they encounter different business operations and different kinds of accounting records and controls. It follows that the auditors must tailor the form the content of their working papers to fit the circumstances of each engagement.

5.5 FORM AND CONTENT OF WORKING PAPERS

Working papers should record the auditors' planning, the nature, timing, and extent of the audit procedures performed, and the conclusions drawn from the audit evidence obtained. Auditors should record in their working papers their reasoning on all significant matters, which require the exercise of judgment, and their conclusions thereon.

Auditors cannot record everything they consider. Therefore judgment must be used as to the extent of working papers, based on what would be necessary to provide an experienced auditor, with no previous connection with the audit, with an understanding of the work performed and the basis of the decision taken. Difficult areas of judgment or questions of principle may be questioned by a third party with the benefit of hindsight. In such circumstances it is important to be able to demonstrate the relevant facts known at the time the auditors reached their conclusion.

The form and content of working papers are affected by matters such as:

- the nature of engagement,
- the form of the auditors' report,
- the nature of complexity of the entity's business,
- the nature and condition of the entity's accounting and internal control system,
- the needs in the particular circumstances for direction, supervision and review of the work of members of the audit team, and
- the specific methodology and technology the auditors use.

The accounting standard warns on the use of standardized working papers like checklists, specimen letters etc, which may improve the efficiency with which such working papers are prepared and reviewed. While they facilitate the delegation of work and provide a means to control its quality, it is never appropriate to follow mechanically a standard approach to the conduct and documentation of the audit without regard to the need to exercise professional judgment.

While auditors utilize schedules, analyses etc prepared by the entity, they require evidence that such information is properly prepared.

Each working paper must have a header at the top. The header should have the name of the client, the purpose of the work paper (often the name of the account(s) on which it is based), and the financial statement date. Information which may be in footer (at the bottom of the work paper) includes the preparer's name, the date of preparation, and the reviewer's (or approver's) initials. Note that these three items (preparer's name, date of preparation, and the reviewer's initials) sometimes appear at the top of the working paper rather than at the bottom.

Work papers usually employ symbols and abbreviations to avoid writing this out in full. The symbols to be utilized vary from firm to firm. Common symbols to be used throughout the working papers are often defined in a separate symbol (or legend, key) sheet at the back of the working paper. Examples of symbols sometimes used are as follows:

¥	-	Agrees with last year's client balance
Ø	-	Agrees to working trial balance
~	-	Item complies with internal control procedure
F	-	Column has been footed

- CF** - Row has been cross footed
EX - Amounts have extended

Working papers should be indexed and cross-referenced for each type of use. To illustrate indexing, current assets could be section "B". The lead schedule for Cash on hand would then be B-1, and supporting schedule for Petty Cash would be B-1-1. The lead schedule for cash in bank would be B-2; the bank reconciliation (supporting schedule) for the main checking account would be B-2-1 and so on.

Each working paper should be self-contained, and it should be easily understood by reader without having to refer to other working papers. Included in the substance of the working papers are the composition of the balance or transactions being examined, the particular audit procedures performed, the auditor's finding, the auditor's evaluation, conclusions, and recommended adjustment (if any).

5.6 TYPES OF WORKING PAPERS

There are certain general categories into which most working papers may be grouped; these are as follows:

1. Audit administrative working papers

Auditing Princ. and Pract.s sophisticated activity requiring planning, supervision, control and coordination. Certain working papers are specifically designed to aid the auditors in the planning and administration of engagements. These working papers include audit plans and programs, internal control questionnaires and flowcharts, engagement letters, and time budgets. Memoranda of the planning process and significant discussions with client management are also considered Administrative Working Papers.

2. Working trial balance

The working trial balance is a schedule listing the balances of the accounts in the general ledger for the current and previous year, and also providing columns for the auditors proposed adjustments are reclassifications and for the final amounts that will appear in the financial statements. A working trial balance is the "backbone" of the entire set of audit working papers; it is key schedule that controls and summarizes all supporting papers.

3. Lead schedules

Separate Lead Schedules (also called Grouping Sheets or Summary Schedules) are set up to combine similar general ledger accounts, the total of which appears on the working trial balance as single amount. For example, a lead schedule for Cash might combine the following general ledger accounts: Petty Cash,

General bank account, Factory Payroll bank account, and Dividend bank account. Similarly lead schedule would be set up for Accounts Receivable, Inventories, Stockholders' Equity, Net sales and for other balance sheet or income statement captions.

4. Adjusting journal entries and reclassification entries

During the course of an audit engagement, the auditors may discover various types of misstatement in the client's financial statements and accounting records. These misstatements may be large or small in amount; they may arise from the omission of transactions or from the use of incorrect amounts or they may result from improper classification or cutoff, or from misinterpretation of transactions. Generally, these misstatements are accidental errors; however, the auditor may discover fraud in the account records.

To correct material errors or fraud discovered in the financial statements or accounting records, the auditors draft adjusting journal entries (AJEs), which they recommend for entry in the client's accounting records. In addition, the auditors develop reclassification journal entries (RJE) for items that, although correctly recorded in the accounting records, must be reclassified for fair presentation in the client's financial statement. For example, accounts receivable with large credit balances should be reclassified as a liability in the balance sheet. Reclassification entries affect only the financial statement presentation; therefore, they are not recorded in the client's accounting records. Reclassification entries appear only on accounting worksheet.

5. Supporting schedules

Although all types of working papers may loosely be called schedules, auditors prefer to use this term to describe a listing of the elements or details comprising the balance in an asset or liability account at a specific date. Thus, a list of amounts owed to vendors making up the balance of the Trade Accounts Payable account is properly described as a Schedule.

6. Analysis of ledger account

An analysis of a ledger account is another common type of audit working paper. The purpose of an analysis is to show all changes in an asset, liability, equity, revenue, or expense account during the period covered by the audit. If a number of the changes are individually immaterial, they may be recorded as a single item in the analysis working paper. Account analysis are most useful in the substantiating those accounts affected by relatively few transactions during the year. Example includes plant asset accounts, long-term debt accounts, capital stock accounts, and retained earnings.

To analyze ledger account, the auditors first list the beginning balance and indicate the nature of the items comprising this balance. Next, the auditors list and investigate the nature of all debits and credits to the account during the period. These entries, when combined with the beginning balance, produce a figure representing the balance in the account as of the audit date. If any misstatement or omissions of importance are detected during this analysis of the account, the necessary adjusting journal entry approved by the client's is entered on the working papers to produce the adjusted balance required for the financial statement.

7. Reconciliations

Frequently, auditors wish to prove the relationship between amounts obtained from different sources. When they do so, they obtain or prepare working papers known as reconciliations. These reconciliations provide evidence as to the accuracy of one or both of the amounts and are important to the audit of many accounts, including cash, accounts receivable and inventories.

8. Computational working papers

Another type of supporting working paper is the computational working papers. The auditor's approach to verifying certain types of accounts and other figures is to making an independent computation and compare their results with the amounts shown by the client's records. Example of amounts that might be verified by computation that are interest expenses, depreciation, payroll taxes, income taxes, pension liabilities and earnings per share.

9. Corroborating documents

Auditing Princ. and Pract.s not limited to the examination of financial records, and working papers are not confined to schedule and analyses. During the course of an audit, the auditors may gather much purely expository material to substantiate their report. One common example is copies of minutes of directors' and stockholders' meetings. Other examples of corroborate documents include copies of articles of incorporation and bylaws; copies of important contracts, bond indentures, and mortgages; memoranda pertaining to examination of records; audit confirmation; and representation letter from the client and from the client's legal counsel.

5.7 ORGANIZATION OF WORKING PAPER

The auditors usually maintain two files of working papers for each client: (1) Current file for every completed audit, and (2) A Permanent file of relatively unchanging data.

Current file

The current file contains information which is related to the current year's audit. The current file normally makes up the bulk of the work papers. The current files will contain three basic elements a working trial balance, lead schedules and supporting schedules which are discussed above. (Please refer the types of working papers above)

Permanent file

The permanent file contains documents which are on-going significance for the client from year to year. This file may contain information about the client's industry. It should contain documents related to the organization itself, such as articles of incorporation, narrative descriptions of its activities, organizational charts, and related parties. It should also include information about the accounting system; the chart of the accounts, computer hardware and software in use, and a description of internal controls. It should also contain documents of a long-term nature which are related to the client's business, such as copies of multi-year contracts, leases, insurance policies, pension plan, and board minutes which represent significant decisions etc. It should be updated as necessary from year to year.

5.8 GUIDELINES FOR PREPARATION OF WORKING PAPERS

1. Working papers must be clean, neat and legible.
2. All question and exception noted in the working papers be resolved, hopefully before the end of the fieldwork, and certainly before the report is issued. For example, if the auditor notes during the examination of inventory that several items are possibly overstated, he/she do further investigation in order to make a surer conclusion. As a practical matter in scheduling, the auditor should always leave time for this, especially if the auditee is located some distance from the auditor's office.
3. Only statements of fact and professional judgment should appear on working papers. All conclusions or inference should be adequately and carefully supported. The language employed in the working papers should be formal, precise and cautions. For example, words like "appears to be adequate or inadequate" should be used rather than "it is good or bad."
4. Brackets, instead of red ink, should be used to show negative numbers. This is especially useful if the papers need to be photocopied or microfilmed later, on which media colors do not generally appear. Consistency should be observed on the use of brackets. The auditor should decide on whether brackets will be used to indicate balances that are different from normal, (e.g. debit balances in accounts

payable, credit balances in accounts receivable), or they will always be used for credit balances only.

5. Time should be economized as much possible in the preparation of working papers. This can be achieved by assigning some working papers to be prepared for the auditor by the Client's employees, which are then examined by the auditor.

5.9 STORAGE, OWNERSHIP AND CONFIDENTIALITY OF WORKING PAPERS

Auditors should adopt appropriate procedures for maintaining the confidentiality and safe custody of their working papers. Working Papers should be stored in a secure place, and protected from unauthorized use. Recall that the auditor's code of ethics calls for the auditor to keep information about client's confidential (rule 301: confidential client information)

Statute does not set down the period of retention of audit working papers; judgment must be used; and further consideration should be given to the matter before their destruction. The papers should also be sheltered from physical damage, such as water leads and fire. In the past, microfilm / microfiche has been employed for storage to save space instead of keeping of all the original papers. Current technology allows for working papers to be stored electronically on computers, CDs, etc. the methods of these types of storage are different, but the aims (i.e. protection from unauthorized use and physical damage) are the same.

Working papers are the property of the auditors. They are not a substitute for, not part, of the entity's accounting records. Auditors must follow ethical guidance on the confidentiality of audit working papers. They may, at their discretion, release parts of or whole working papers to the entity, as long as disclosure does not undermine the independence or validity of the audit process. Information should not be made available to third parties without the permission of the entity.

CHAPTER SUMMARY

An important part of every audit is determining the proper types and amounts of audit evidence to gather. Auditors use eight types of evidence in an audit. The persuasiveness of the evidence depends

on both its appropriateness and sufficiency. The appropriateness of audit evidence is determined by its relevance in meeting audit objectives and its reliability.

Audit documentation is an essential part of every audit for effectively planning the audit, providing a record of the evidence accumulated and the results of the tests, deciding the proper type of audit report, and reviewing the work of assistants. CPA firms establish their own policies and approaches to audit documentation to make sure that these objectives are met. High-quality CPA firms make sure that audit documentation is properly prepared and is sufficient for the circumstances

in the audit. Auditors use working papers to document the evidences they have obtained and their activities. The proper completion of working papers is fundamental to the audit opinion to be given. Working papers are property of the auditor s and are designed to assist the auditors in coordinating and reviewing the audit work, provide support for the audit report, document the auditors' compliance with the generally accepted auditing standards, and facilitate future audits of the client. They should show when and by whom the work was performed and reviewed. Auditors must store working papers properly.

SELF TEST QUESTIONS

PART I- TRUE OR FALSE

Say 'true' if the statement is correct and 'false' if it is wrong!

1. The current files include all audit documentation applicable to the year under audit.
2. Recalculation involves rechecking a sample of calculations made by the client.
3. Internal documents are considered more reliable evidence than external documents.
4. Appropriateness cannot be improved by selecting a larger sample size or different population items
5. Relevancy of evidence refers to the degree to which evidence can be believable or worthy of trust.

PART II: FILL THE BLANK SPACE**Fill the blank space using the correct word!**

1. _____ a measure of the quality of evidence; appropriate evidence is relevant and reliable in meeting audit objectives for classes of transactions, account balances, and related disclosures.
2. _____ auditors' files that contain data of a historical or continuing nature pertinent to the current audit such as copies of articles of incorporation, bylaws, bond indentures, and contracts
3. _____ a document, such as a vendor's invoice, that has been used by an outside party to the transaction being documented and that the client now has or can easily obtain
4. _____ an audit schedule that contains the detailed accounts from the general ledger making up a line item total in the working trial balance
5. _____ the degree to which the auditor is convinced that the evidence supports the audit opinion; the two determinants of persuasiveness are the appropriateness and sufficiency of the evidence

PART III. SHORT ANSWER**Give brief and neat answers for the following questions (give further explanation if needed)!**

1. Define 'sufficiency and appropriateness' in relation to audit evidence.

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2. What generalizations are made in relation to the sources and nature of audit evidence?

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3. What are the main procedures for obtaining audit evidence?

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4. What major aspects should the audit working papers record?

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5. What matters affect the form and content of working papers?

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6. What details should audit working papers show?

CHAPTER SIX

AUDIT REPORT

6.0 LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- ❖ Describe the standard audit report
- ❖ Explain the main elements of an audit report
- ❖ Identify the circumstances that may result in qualified opinions, adverse opinions, and disclaimers of opinion.
- ❖ Explain the circumstances that result in the addition of explanatory language to the auditors' standard report.

6.1. INTRODUCTION

Dear learners! In the previous chapters you have seen overview of an audit and its professional and ethical standards; audit planning, programming and process; use of internal control in an audit; and obtaining audit evidence. In this chapter, the main objective is to help you understand the different types of reports which may be issued by auditors based on their findings. After obtaining the necessary evidence and completing the field work, the auditors should give their opinion on whether the financial statements are fair and true in material aspects. The audit report is the means by which the auditors express their opinion on the truth and fairness of a company's financial statement addressed principally for the shareholders, but also for the users. Statute has consistently recognized its importance by requiring that certain mandatory statements appear in the report.

6.2. REQUIREMENTS FOR AUDIT REPORT

Expressing an independent and expert opinion on the fairness of financial statements is the most frequently performed attestation service rendered by the public accounting profession. This opinion, which is expressed in the auditors' report, provides users financial statements with reasonable assurance that the statements are in conformity with generally accepted accounting principles. For users to understand the full implication of the auditors' opinion, it is important for the report to comply with the fourth standard of reporting which states as follows:

The (auditor's) report shall either contain an expression of opinion regarding financial statements, taken as whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditors' name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditors' work, if any, and the degree of responsibility

The auditors' standard report meets this reporting standard by;

- ✓ stating that the audit was performed in conformity with generally accepted auditing standards, and
- ✓ Expressing an opinion that the client's financial statements are presented fairly in conformity with generally accepted accounting principles.

However, if there are material deficiencies in the client's financial statements or limitation in the audit, or if there are other unusual conditions about which the reader of the financial statements should be informed, auditors' cannot issue the standard report. Instead, they must carefully modify their report to make these problems or conditions known to users of the audited financial statements.

Activity Dear learner! Refer back your financial accounting modules and the first chapter of this module, and mention the Generally Accepted Accounting Principles (GAAP) and the Generally Accepted Auditing Standards (GAAS)? Which principle/s do you think is/are violated if an adjusting entry for prepayments was not prepared at the end of a fiscal period?

International Auditing Standards require the auditors to state explicitly whether in the auditors' opinion the annual accounts have been properly prepared in accordance with the GAAP and in particular whether a true and fair view is given:

- ✓ In the balance sheet, of the state of the company's affairs at the end of financial year.
- ✓ In the profit and loss account, of the company's profit or loss for the financial year; and
- ✓ In the case of group accounts, of the state of affairs at the end of financial year and the profit or loss for the year of undertakings included in the consolidation, so far as concerns member of the company.

6.3. TYPE OF REPORTS EXPRESSING AUDIT OPINIONS

The auditors' opinion when expressing an opinion on financial statements may be summarized as follows:

- 1) An Unqualified Opinion
- 2) A Qualified Opinion
- 3) An Adverse Opinion
- 4) A Disclaimer of Opinion

1). STANDARD UNQUALIFIED AUDIT REPORT

To allow users to understand audit reports, AICPA professional standards provide uniform wording for the auditor's report, as illustrated in the auditor's standard unqualified audit report in Table 6-1. Different auditors may alter the wording or presentation slightly, but the meaning will be the same.

Parts of Standard Unqualified Audit Report

The auditor's standard unqualified audit report contains seven distinct parts, and these are labeled in bold letters in the margin beside Figure 6-1.

1. **Report title.** Auditing standards require that the report be titled and that the title include the word independent. For example, appropriate titles include "independent auditor's report," "report of independent auditor," or "independent accountant's opinion." The requirement that the title include the word independent conveys to users that the audit was unbiased in all aspects.
2. **Audit report address.** The report is usually addressed to the company, its stockholders, or the board of directors. In recent years, it has become customary to address the report to the board of directors and stockholders to indicate that the auditor is independent of the company.

3. **Introductory paragraph.** The first paragraph of the report does three things: First, it makes the simple statement that the CPA firm has done an audit. This is intended to distinguish the report from a compilation or review report. The scope paragraph clarifies what is meant by an audit. Second, it lists the financial statements that were audited, including the balance sheet dates and the accounting periods for the income statement and statement of cash flows. The wording of the financial statements in the report should be identical to those used by management on the financial statements. Notice that the report in Figure 7-1 is on comparative financial statements. Therefore, a report on both years' statements is needed. Third, the introductory paragraph states that the statements are the responsibility of management and that the auditor's responsibility is to express an opinion on the statements based on an audit. The purpose of these statements is to communicate that management is responsible for selecting the appropriate accounting principles and making the measurement decisions and disclosures in applying those principles and to clarify the respective roles of management and the auditor.
4. **Scope paragraph.** The scope paragraph is a factual statement about what the auditor did in the audit. This paragraph first states that the auditor followed U.S. Generally accepted auditing standards. For an audit of a public company, the paragraph will indicate that the auditor followed standards of the Public Company Accounting Oversight Board. Because financial statements prepared in accordance with U.S. accounting principles and audited in accordance with U.S. auditing standards are available throughout the world on the Internet, the country of origin of the accounting principles used in preparing the financial statements and auditing standards followed by the auditor are identified in the audit report.

The scope paragraph states that the audit is designed to obtain reasonable assurance about whether the statements are free of material misstatement. The inclusion of the word material conveys that auditors are responsible only to search for significant misstatements, not minor misstatements that do not affect users' decisions. The use of the term reasonable assurance is intended to indicate that an audit cannot be expected to completely eliminate the possibility that a material misstatement will exist in the financial statements. In other words, an audit provides a high level of assurance, but it is not a guarantee.

The remainder of the scope paragraph discusses the audit evidence accumulated and states that the auditor believes that the evidence accumulated was appropriate for the circumstances to express

the opinion presented. The words test basis indicates that sampling was used rather than an audit of every transaction and amount on the statements. Whereas the introductory paragraph of the report states that management is responsible for the preparation and content of the financial statements, the scope paragraph states that the auditor evaluates the appropriateness of those accounting principles, estimates, and financial statement disclosures and presentations given.

5. **Opinion paragraph.** The final paragraph in the standard report states the auditor's conclusions based on the results of the audit. This part of the report is so important that often the entire audit report is referred to simply as the auditor's opinion. The opinion paragraph is stated as an opinion rather than as a statement of absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. The phrase in our opinion indicates that there may be some information risk associated with the financial statements, even though the statements have been audited. The opinion paragraph is directly related to the first and fourth generally accepted auditing reporting standards listed in chapter 2. The auditor is required to state an opinion about the financial statements taken as a whole, including a conclusion about whether the company followed U.S. generally accepted accounting principles or the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). One of the controversial parts of the auditor's report is the meaning of the term present fairly. Does this mean that if generally accepted accounting principles are followed, the financial statements are presented fairly, or something more? Occasionally, the courts have concluded that auditors are responsible for looking beyond generally accepted accounting principles to determine whether users might be misled, even if those principles are followed. Most auditors believe that financial statements are "presented fairly" when the statements are in accordance with generally accepted accounting principles, but that it is also necessary to examine the substance of transactions and balances for possible misinformation.
6. **Name of CPA firm.** The name identifies the CPA firm or practitioner who performed the audit. Typically, the firm's name is used because the entire CPA firm has the legal and professional responsibility to ensure that the quality of the audit meets professional standards.
7. **Audit report date.** The appropriate date for the report is the one on which the auditor completed the auditing procedures in the field. This date is important to users because it

indicates the last day of the auditor's responsibility for the review of significant events that occurred after the date of the financial statements. In the audit report in table 7-1 balance sheet is dated December 31, 2013, and the audit report is dated February 15, 2014. This indicates that the auditor has searched for material unrecorded transactions and events that occurred up to February 15, 2014.

Standard Unqualified Report on Comparative Statements for a U.S. Public Company

ANDERSON and ZINDER, P.C. Certified Public Accountants Suite 100 Park Plaza East Denver, Colorado 80110 303/359-0800	
Independent Auditor's Report	Report Title
To the Stockholders General Ring Corporation	Audit Report Address
We have audited the accompanying balance sheets of General Ring Corporation as of December 31, 2012 and 2013, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.	Introductory Paragraph (Factual Statement)
We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and	Scope Paragraph (Factual Statement)

significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.	
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Ring Corporation as of December 31, 2012 and 2013, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.	Opinion Paragraph (Conclusions)
ANDERSON AND ZINDER, P.C., CPAs	Name of CPA Firm
February 15, 2014	Audit Report Date (Date Audit Field Work Is Completed)

Table 6.1 Standard Unqualified Reports

Conditions for Standard Unqualified Audit Report

The standard unqualified audit report is issued when the following conditions have been met:

1. All statements—balance sheet, income statement, statement of retained earnings, and statement of cash flows—are included in the financial statements.
2. The three general standards have been followed in all respects on the engagement.
3. Sufficient appropriate evidence has been accumulated, and the auditor has conducted the engagement in a manner that enables him or her to conclude that the three standards of field work have been met.
4. The financial statements are presented in accordance with U.S. generally accepted accounting principles. This also means that adequate disclosures have been included in the footnotes and other parts of the financial statements.
5. There are no circumstances requiring the addition of an explanatory paragraph or modification of the wording of the report. When these conditions are met, the standard

unqualified audit report, as shown in table 7-1, is issued. The standard unqualified audit report is sometimes called a clean opinion because there are no circumstances requiring a qualification or modification of the auditor's opinion. The standard unqualified report is the most common audit opinion. Sometimes circumstances beyond the client's or auditor's control prevent the issuance of a clean opinion. However, in most cases, companies make the appropriate changes to their accounting records to avoid a qualification or modification by the auditor.



Unqualified audit report with explanatory paragraph or modified word

The remainder of this chapter deals with reports, other than standard unqualified reports, on the audit of financial statements. In certain situations, an unqualified audit report on the financial statements is issued, but the wording deviates from the standard unqualified report. The unqualified audit report with explanatory paragraph or modified wording meets the criteria of a complete audit with satisfactory results and financial statements that are fairly presented, but the auditor believes it is important or is required to provide additional information. In a qualified, adverse, or disclaimer report, the auditor either has not performed a satisfactory audit, is not satisfied that the financial statements are fairly presented, or is not independent.

The following are the most important causes of the addition of an explanatory paragraph or a modification in the wording of the standard unqualified report:

- ❖ Lack of consistent application of generally accepted accounting principles
- ❖ Substantial doubt about going concern
- ❖ Auditor agrees with a departure from promulgated accounting principles
- ❖ Emphasis of a matter
- ❖ Reports involving other auditors

The first four reports all require an explanatory paragraph. In each case, the three standard report paragraphs are included without modification, and a separate explanatory paragraph follows the opinion paragraph. Only reports involving the use of other auditors use a modified wording report. This report contains three paragraphs, and all three paragraphs are modified.



Lack of Consistent Application of GAAP

The second reporting standard requires the auditor to call attention to circumstances in which accounting principles have not been consistently observed in the current period in relation to the

preceding period. Generally accepted accounting principles require that changes in accounting principles or their method of application be to a preferable principle and that the nature and impact of the change be adequately disclosed. When a material change occurs, the auditor should modify the report by adding an explanatory paragraph after the opinion paragraph that discusses the nature of the change and points the reader to the footnote that discusses the change. The materiality of a change is evaluated based on the current year effect of the change. An explanatory paragraph is required for both voluntary changes and required changes due to a new accounting pronouncement.



Consistency Versus Comparability

The auditor must be able to distinguish between changes that affect consistency and those that may affect comparability but do not affect consistency. The following are examples of changes that affect consistency and therefore require an explanatory paragraph if they are material:

1. Changes in accounting principles, such as a change from FIFO to LIFO inventory valuation
 2. Changes in reporting entities, such as the inclusion of an additional company in combined financial statements
 3. Corrections of errors involving principles, by changing from an accounting principle that is not generally acceptable to one that is generally acceptable, including correction of the resulting error
- Changes that affect comparability but not consistency and therefore need not be included in the audit report include the following:
- Changes in an estimate, such as a decrease in the life of an asset for depreciation purposes
 - Error corrections not involving principles, such as a previous year's mathematical error
 - Variations in format and presentation of financial information
 - Changes because of substantially different transactions or events, such as new endeavors in research and development or the sale of a subsidiary
- Items that materially affect the comparability of financial statements generally require disclosure in the footnotes. A qualified audit report for inadequate disclosure may be required if the client refuses to properly disclose the items.



Substantial Doubt about Going Concern

Even though the purpose of an audit is not to evaluate the financial health of the business, the auditor has a responsibility under auditing standards to evaluate whether the company is likely to continue as

a going concern. For example, the existence of one or more of the following factors causes uncertainty about the ability of a company to continue as a going concern:

1. Significant recurring operating losses or working capital deficiencies
2. Inability of the company to pay its obligations as they come due
3. Loss of major customers, the occurrence of uninsured catastrophes such as an earthquake or flood, or unusual labor difficulties
4. Legal proceedings, legislation, or similar matters that have occurred that might jeopardize the entity's ability to operate the auditor's concern in such situations is the possibility that the client may not be able to continue its operations or meet its obligations for a reasonable period. For this purpose, a reasonable period is considered not to exceed 1 year from the date of the financial statements being audited.

When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, an unqualified opinion with an explanatory paragraph is required, regardless of the disclosures in the financial statements. Auditing standards permit but do not require a disclaimer of opinion when there is substantial doubt about going concern. The criteria for issuing a disclaimer of opinion instead of adding an explanatory paragraph are not stated in the standards, and this type of opinion is rarely issued in practice. An example for which a disclaimer might be issued is when a regulatory agency, such as the Environmental Protection Agency, is considering a severe sanction against a company and, if the proceedings result in an unfavorable outcome, the company will be forced to liquidate.



Auditor Agrees with a Departure from a Promulgated Principle

Rule 203 of the AICPA Code of Professional Conduct states that in unusual situations, a departure from a generally accepted accounting principle may not require a qualified or adverse opinion. However, to justify an unqualified opinion, the auditor must be satisfied and must state and explain, in a separate paragraph or paragraphs in the audit report, that adhering to the principle would produce a misleading result in that situation.



Emphasis of a Matter

Under certain circumstances, the CPA may want to emphasize specific matters regarding the financial statements, even though he or she intends to express an unqualified opinion. Normally, such

explanatory information should be included in a separate paragraph in the report. Examples of explanatory information the auditor may report as an emphasis of a matter include the following:

- ❖ The existence of significant related party transactions
- ❖ Important events occurring subsequent to the balance sheet date
- ❖ The description of accounting matters affecting the comparability of the financial statements with those of the preceding year
- ❖ Material uncertainties disclosed in the footnotes



Reports Involving Other Auditors

When the CPA relies on a different CPA firm to perform part of the audit, which is common when the client has several widespread branches or subdivisions, the principal CPA firm has three alternatives. Only the second is an unqualified report with modified wording.

1. **Make No Reference in the Audit Report.** When no reference is made to the other auditor, a standard unqualified opinion is given unless other circumstances require a departure.

This approach is typically followed when the other auditor audited an immaterial portion of the statements, the other auditor is well known or closely supervised by the principal auditor, or the principal auditor has thoroughly reviewed the other auditor's work. The other auditor is still responsible for his or her own report and work in the event of a lawsuit or SEC action.

2. **Make Reference in the Report (Modified Wording Report):** This type of report is called a shared opinion or report. A shared unqualified report is appropriate when it is impractical to review the work of the other auditor or when the portion of the financial statements audited by the other CPA is material in relation to the whole.

Notice that the report does not include a separate paragraph that discusses the shared responsibility, but does so in the introductory paragraph and refers to the other auditor in the scope and opinion paragraphs. The portions of the financial statements audited by the other auditor can be stated as percentages or absolute amounts.

Activity**Dear learners!**

1. List the seven parts of a standard unqualified audit report and explain the meaning of each part. How do the parts compare with those found in a qualified report?
2. What are the purposes of the scope paragraph in the auditor's report? Identify the most important information included in the scope paragraph.
3. What are the purposes of the opinion paragraph in the auditor's report? Identify the most important information included in the opinion paragraph.

1. QUALIFIED OPINION

A qualified opinion report can result from a limitation on the scope of the audit or failure to follow generally accepted accounting principles. A qualified opinion report can be used only when the auditor concludes that the overall financial statements are fairly stated. A disclaimer or an adverse report must be used if the auditor believes that the condition being reported on is highly material. Therefore, the qualified opinion is considered the least severe type of departure from an unqualified report.

A qualified report can take the form of a qualification of both the scope and the opinion or of the opinion alone. A scope and opinion qualification can be issued only when the auditor has been unable to accumulate all of the evidence required by generally accepted auditing standards.

Therefore, this type of qualification is used when the auditor's scope has been restricted by the client or when circumstances exist that prevent the auditor from conducting a complete audit. The use of a qualification of the opinion alone is restricted to situations in which the financial statements are not stated in accordance with GAAP.

When an auditor issues a qualified report, he or she must use the term except for in the opinion paragraph. The implication is that the auditor is satisfied that the overall financial statements are correctly stated "except for" a specific aspect of them. Examples of this qualification are given later in this chapter. It is unacceptable to use the phrase except for with any other type of audit opinion.

Activity

Dear learners! Distinguish between an unqualified report with an explanatory paragraph or modified wording and a qualified report. Give examples when an explanatory paragraph or modified wording should be used in an unqualified opinion.

2. ADVERSE OPINION

An adverse opinion is used only when the auditor believes that the overall financial statements are so materially misstated or misleading that they do not present fairly the financial position or results of operations and cash flows in conformity with GAAP. The adverse opinion report can arise only when the auditor has knowledge, after an adequate investigation, of the absence of conformity. This is uncommon and thus the adverse opinion is rarely used.

3. DISCLAIMER OF OPINION

A disclaimer of opinion is issued when the auditor has been unable to satisfy himself or herself that the overall financial statements are fairly presented. The necessity for disclaiming an opinion may arise because of a severe limitation on the scope of the audit or a non independent relationship under the Code of Professional Conduct between the auditor and the client. Either of these situations prevents the auditor from expressing an opinion on the financial statements as a whole. The auditor also has the option to issue a disclaimer of opinion for a going concern problem.

The disclaimer is distinguished from an adverse opinion in that it can arise only from a lack of knowledge by the auditor, whereas to express an adverse opinion, the auditor must have knowledge that the financial statements are not fairly stated. Both disclaimers and adverse opinions are used only when the condition is highly material.

Activity

Dear learner! Distinguish between a qualified opinion, an adverse opinion, and a disclaimer of opinion, and explain the circumstances under which each is appropriate.

CHAPTER SUMMARY

Generally Accepted Auditing Standards require the auditor to state explicitly whether in the auditors' opinion the annual financial statements have been properly prepared in accordance with GAAP and in particular whether a true and fair view is given. This chapter explained the different types of reports the auditors' issue. The main elements of an unqualified (standard) audit report are:-a title, addressee, an introductory paragraph clarifying the responsibilities of auditors and management, the scope paragraph describing the nature of the audit, a clear statement of auditors' opinion, address and signature of the audit firm. The auditors alternatives when expressing an opinion are a standard unqualified opinion- if the financial statement do not materially depart from GAAP with no scope limitation, an unqualified opinion with explanatory language-if explanatory language is added to the standard opinion, a qualified opinion-if there is material departure from GAAP and scope limitation is imposed by the client, an adverse opinion- if deficiencies in the financial statements are so significant that the financial statements taken as whole are misleading , and a disclaimer of opinion-if the auditors were unable to form an opinion or did not form an opinion on the financial statements .

SELF TEST QUESTIONS

PART I- TRUE OR FALSE

Say 'true' if the statement is correct and 'false' if it is wrong!

1. The scope paragraph states that the audit is designed to obtain reasonable assurance about whether the statements are free of material misstatement.
2. The appropriate date for the report is the one on which the auditor completed the auditing procedures in the field.
3. Auditing standards permit but do not require a disclaimer of opinion when there is substantial doubt about going concern
4. The statement of management's responsibilities is always included in the auditors' report.
5. The inclusion of an emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion on the financial statements.

PART II: FILL THE BLANK SPACE

Fill the blank space using the correct word!

1. _____ paragraph is a factual statement about what the auditor did in the audit.
2. A report issued when the auditor believes the financial statements are so materially misstated or misleading as a whole that they do not present fairly the entity's financial position or the results of its operations and cash flows in conformity with GAAP is called _____.
3. _____ is a report issued when the auditor is not able to become satisfied that the overall financial statements are fairly presented or the auditor is not independent .
4. _____ the report a CPA issues when all auditing conditions have been met, no significant misstatements have been discovered and left uncorrected, and it is the auditor's opinion that the financial statements are fairly stated in accordance with GAAP .
5. _____ a report issued when the auditor believes that the overall financial statements are fairly stated but that either the scope of the audit was limited or the financial data indicated a failure to follow GAAP.

PART III. SHORT ANSWER

Give brief and neat answers for the following questions (give further explanation if needed)

1. What are the basic elements of the auditors' report?

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2. Write down a description of the directors' responsibilities, which should be included in the financial statements?

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3. What will the judgment of whether the financial statements show a true and fair view entail?

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4. When will a qualified opinion be issued?

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5. What is the effect of a limitation of scope on the audit report?

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6. When should the auditors' report be dated?

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GLOSSARY

AICPA—American Institute of Certified Public Accountants, a voluntary organization of CPAs that sets professional requirements, conducts research, and publishes materials relevant to accounting, auditing, management consulting services, and taxes.

Auditing—the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.

Audit strategy—overall approach to the audit that considers the nature of the client, risk of significant misstatements, and other factors such as the number of client locations and past effectiveness of client controls

Acceptable audit risk—a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been issued. **Analytical procedures**—use of comparisons and relationships to assess whether account balances or other data appear reasonable

Appropriateness of evidence—a measure of the quality of evidence; appropriate evidence is relevant and reliable in meeting audit objectives for classes of transactions, account balances, and related disclosures.

Audit documentation—the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement

Audit procedure—detailed instruction for the collection of a type of audit evidence

Audit program—list of audit procedures for an audit area or an entire audit; the audit program always includes audit procedures and may also include sample sizes, items to select, and timing of the tests. **Adverse opinion**—a report issued when the auditor believes the financial statements are so materially misstated or misleading as a whole that they do not present fairly the entity's financial position or the results of its operations and cash flows in conformity with GAAP.

Confirmation—the auditor's receipt of a direct written or electronic response from a third party verifying the accuracy of information requested

Current files—all audit files applicable to the year under audit

Chart of accounts—a listing of all the entity's accounts, which classifies transactions into individual balance sheet and income statement accounts

Collusion— a cooperative effort among employees to steal assets or misstate records.

Documentation—the auditor's inspection of the client's documents and records to substantiate the information that is or should be included in the financial statements.

Disclaimer of opinion—a report issued when the auditor is not able to become satisfied that the overall financial statements are fairly presented or the auditor is not independent

External document—a document, such as a vendor's invoice, that has been used by an outside party to the transaction being documented and that the client now has or can easily obtain.

Financial statement audit—an audit conducted to determine whether the overall financial statements of an entity are stated in accordance with specified criteria (usually U.S. or international accounting standards).

Generally accepted auditing standards (GAAS)—10 auditing standards, developed by the AICPA, consisting of general standards, standards of field work, and standards of reporting, along with interpretations; often called auditing standards.

Internal control—a process designed to provide reasonable assurance regarding the achievement of management's objectives in the following categories:

- (1) Reliability of financial reporting,
- (2) Effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations

Initial audit planning—involves deciding whether to accept or continue doing the audit for the client, identifying the client's reasons for the audit, obtaining an engagement letter, and developing an audit strategy.

Inherent risk—a measure of the auditor's assessment of the likelihood that there are material misstatements in a segment before considering the effectiveness of internal control

International Standards on Auditing (ISAs)—statements issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants to promote international acceptance of auditing standards.

Inquiry—the obtaining of written or oral information from the client in response to specific questions during the audit

Internal document—a document, such as an employee time report, that is prepared and used within the client's organization.

Legal liability—the professional's obligation under the law to provide a reasonable level of care while performing work for those served.

Lead schedule—an audit schedule that contains the detailed accounts from the general ledger making up a line item total in the working trial balance.

Material misstatement—a misstatement in the financial statements, knowledge of which would affect a decision of a reasonable user of the statements.

Management letter—an optional letter written by the auditor to a client's management containing the auditor's recommendations for improving any aspect of the client's business.

OFAG- office of the federal auditor general in Ethiopian case.

Observation—the use of the senses to assess client activities.

Permanent files—auditors' files that contain data of a *historical or continuing nature* pertinent to the current audit such as copies of articles of incorporation, bylaws, bond indentures, and contracts

Persuasiveness of evidence—the degree to which the auditor is convinced that the evidence supports the audit opinion; the two determinants of persuasiveness are the appropriateness and sufficiency of the evidence

Physical examination—the auditor's inspection or count of a tangible asset

Public Company Accounting Oversight Board (PCAOB)—Board created by the Sarbanes–Oxley Act to oversee auditors of public companies, including establishing auditing and quality control standards and performing inspections of registered accounting firms.

Statements on Auditing Standards (SASs)—pronouncements issued by the AICPA to interpret generally accepted auditing standards.

Qualified opinion—a report issued when the auditor believes that the overall financial statements are fairly stated but that either the scope of the audit was limited or the financial data indicated a failure to follow GAAP.

Recalculation—the rechecking of a sample of the computations made by the client, including mathematical accuracy of individual transactions and amounts and the adding of journals and subsidiary records

Reliability of evidence—the extent to which evidence is believable or worthy of trust; evidence is reliable when it is obtained (1) from an independent provider, (2) from a client with effective internal controls, (3) from the auditor's direct knowledge, (4) from qualified providers such as law firms and banks, (5) from objective sources, and (6) in a timely manner

Re-performance—the auditor's independent tests of client accounting procedures or controls that were originally done as part of the entity's accounting and internal control system

Standard unqualified audit report—the report a CPA issues when all auditing conditions have been met, no significant misstatements have been discovered and left uncorrected, and it is the auditor's opinion that the financial statements are fairly stated in accordance with GAAP

Sarbanes-Oxley Act—a federal securities law passed in 2002 that provides for additional regulation of public companies and their auditors; the Act established the Public Company Accounting Oversight Board and also requires auditors to audit the effectiveness of internal control over financial reporting.

Securities Act of 1933—a federal statute dealing with companies that register and sell securities to the public; under the statute, third parties who are original purchasers of securities may recover damages from the auditor if the financial statements are misstated, unless the auditor proves that the audit was adequate or that the third party's loss was caused by factors other than misleading financial statements

Securities Exchange Act of 1934—a federal statute dealing with companies that trade securities on national and over-the-counter exchanges; auditors are involved because the annual reporting requirements include audited financial statements

Tests of controls—audit procedures to test the operating effectiveness of controls in support of reduced assessed control risk

Sufficiency of evidence—the quantity of evidence; proper sample size

Supporting schedules—detailed schedules prepared by the client or the auditor in support of specific amounts on the financial statements

Tick marks—symbols used on an audit schedule that provide additional information or details of audit procedures performed.

Unqualified audit report with explanatory paragraph or modified wording—an unqualified report in which the financial statements are fairly presented, but the auditor believes it is important, or is required, to provide additional information.

Unusual fluctuations—significant unexpected differences indicated by analytical procedures between the current year's unaudited financial data and other data used in comparisons

Vouching—the use of documentation to support recorded transactions or amounts

Working trial balance—a listing of the general ledger accounts and their yearend balances

ANSWER KEY FOR SELF TEST QUESTIONS**CHAPTER ONE****PART I: TRUE OR FALSE**

1. False
2. False
3. True
4. True
5. True

PART II: FILL THE BLANK SPACE

1. Auditing
2. Error of compensating
3. Internal audit
4. Independent auditors
5. Internal auditors

CHAPTER TWO**PART I: TRUE OR FALSE**

1. True
2. True
3. True
4. True
5. False

PART II: FILL THE BLANK SPACE

1. Quality control
2. Field work standards
3. Generally Accepted Auditing standards and statements on auditing standards (GAAS and SAS)
4. statements on auditing standards (SAS)
5. Sufficient appropriate audit evidence.

CHAPTER THREE**PART I- MULTIPLE CHOICE QUESTIONS**

1. D
2. D
3. A
4. A
5. A

CHAPTER FOUR**PART I: TRUE OR FALSE**

1. True
2. True
3. True
4. True
5. True

PART II: FILL THE BLANK SPACE

1. Collusion
2. Design of internal control and test the operation effectiveness
3. The control environment
4. Test of control
5. Monitoring

CHAPTER FIVE**PART I: TRUE OR FALSE**

1. True
2. True
3. False
4. True
5. False

PART II: FILL THE BLANK SPACE

1. Appropriateness of evidence
2. Permanent files
3. External document

4. Lead schedule
5. Persuasiveness of evidence

CHAPTER SIX

PART I: TRUE OR FALSE

1. True
2. True
3. True
4. True
5. True

PART II: FILL THE BLANK SPACE

1. The scope paragraph
2. Adverse opinion
3. Disclaimer of opinion
4. Standard unqualified audit report
5. Qualified opinion

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