



**NATIONAL OPEN UNIVERSITY OF NIGERIA**

**SCHOOL OF MANAGEMENT SCIENCES**

**COURSE CODE: ACC 411**

**COURSE TITLE: ADVANCE AUDIT AND ASSURANCE**

**COURSE  
GUIDE**

**ACC 411  
ADVANCE AUDIT AND ASSURANCE**

**Course Team**      Anthony Idialu Ehiagwina & Faith E. Nnanna  
                                 (Course Adaptors) - NOUN  
                                 Dr. C. I. Okeke (Course Editor) - NOUN  
                                 A. I. Ehiagwina (Course Coordinator) - NOUN  
                                 Dr. I. D. Idrisu (Programme Leader) - NOUN



**NATIONAL OPEN UNIVERSITY OF NIGERIA**

National Open University of Nigeria  
Headquarters  
14/16 Ahmadu Bello Way  
Victoria Island, Lagos

Abuja Office  
5 Dar es Salaam Street  
Off Aminu Kano Crescent  
Wuse II, Abuja

e-mail: [centralinfo@nou.edu.ng](mailto:centralinfo@nou.edu.ng)

URL: [www.nou.edu.ng](http://www.nou.edu.ng)

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## **INTRODUCTION**

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

## **WHAT YOU WILL LEARN IN THIS COURSE**

The course will take you through topics such as audit strategy, audit evidence, test, document and risks, organisation and management of professional office, training, and auditor's liability, ministries and government's agencies, audit procedure, specialised audit, investigation, insolvency, principles of professional ethics, application of professional ethics, local legislations affecting audits, international legislation affecting audits, quality control in audit and assurance reports, assurance reports in audit, emerging issues in audit and assurance, information technology issues in advance audit and assurance.

## **COURSE AIMS**

The aim of the course is to relate to you the concept of auditing, considering the professional and legal requirements in current day practices.

## **COURSE OBJECTIVES**

At the end of this course, you should be able to:

- explain the general concept of audit strategy
- outline what the auditor should do in carrying out an audit assignment
- explain the importance of audit strategy as an effective plan for an audit
- state the points to be considered in audit planning
- state the points to be considered in audit planning memorandum
- state what the auditor should do to be familiar with the client's business and organisation
- explain audit evidence
- explain the various types of audit test and procedures
- describe the use of working papers by the auditor
- state the quality of good audit working papers
- state the content of audit working papers

- state the areas the auditor should be able to assess the risk on
- state the factors that could minimise audit risks
- state the steps involved in the process for designing effective training systems
- describe the most common techniques that could be used for training personnel of an audit firm
- describe the standards for assurance engagement
- state what an engagement letter should contain
- explain the term expectation gap
- state some of the key guidelines in the audit standard
- state the general approaches to negotiation
- state the steps in the process of negotiation
- outline the provision of CAMA in respect of auditors' liability
- describe an office and its facilities
- state what the partnership deed should cover;
- state the various aspects of quality control in an audit firm.

## **COURSE MATERIAL**

The major components of the course are:

1. Course guide
2. Study units
3. Textbooks and References
4. Assignment files
5. Presentation schedule

## **STUDY UNITS**

The study units are as listed below:

### **Module 1 Audit Planning and Control**

- |        |  |
|--------|--|
| Unit 1 | Audit Strategy                                     |
| Unit 2 | Audit Evidence, Test, Document and Risks           |
| Unit 3 | Organisation and Management of Professional Office |
| Unit 4 | Training and Auditors' Liability                   |

### **Module 2 Public Sector and Specialised Audit and Investigation**

- |        |                                    |
|--------|------------------------------------|
| Unit 1 | Ministries and Government Agencies |
| Unit 2 | Audit Procedures                   |
| Unit 3 | Specialised Audit 1                |
| Unit 4 | Specialised Audit 2                |
| Unit 5 | Investigation                      |
| Unit 6 | Insolvency                         |

**Module 3 Audit and Ethics**

- Unit 1 Principles of Professional Ethics
- Unit 2 Application of Professional Ethics
- Unit 3 Local Legislations affecting Audits
- Unit 4 International Legislation affecting Audits
- Unit 5 Quality Control in Audit and Assurance Reports

**Module 4 Assurance Report**

- Unit 1 Assurance Reports in Audit
- Unit 2 Emerging Issues in Audit and Assurance 1
- Unit 3 Emerging Issues in Audit and Assurance 2
- Unit 4 Information Technology Issues in Advance Audit and Assurance 1
- Unit 5 Information Technology Issues in Advance Audit and Assurance 2

**ASSESSMENT**

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

**TUTOR-MARKED ASSIGNMENT**

The Tutor-Marked Assignments (TMAs) at the end of each unit are designed to test your understanding and application of the concepts learned. Besides the preparatory TMAs in the course material to test what has been learnt, it is important that you know that at the end of the course, you must have done your examinable TMAs as they fall due, which are marked electronically. They make up to 30 per cent of the total score for the course.

**FINAL EXAMINATION AND GRADING**

The final examination for this course will consist of questions, which reflect the types of self-assessment exercises and tutor-marked assignments you previously attempted. All areas of the course will be assessed. Make sure you revise the entire course very well before sitting for the final examination. You will find it useful to review your self-assessment exercises, tutor-marked assignments and the comments on them before the examination. The final examination covers information from all parts of the course.

## HOW TO GET THE MOST FROM THIS COURSE

In distance learning, the study units replace the university lecturer. This is one of the great advantages of distance learning. You can read and work through specially designed study materials at your own pace, and at a time and place that suit you best. Think of it as reading the lecture instead of listening to a lecturer. In the same way that a lecturer might set you some reading to do, the study unit will tell you when to read other materials. Just as a lecturer might give you an in-class exercise, the study units provide exercises for you to do at appropriate time.

Each of the units follows a common format. The first item is an introduction to the subject matter of the unit and how a particular unit is integrated with the other units and the course as a whole.

Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit you must go back and check whether you have achieved the objectives. If you make a habit of doing this, you will significantly improve your chances of passing the course.

The main body of the unit guides you through the required reading from other sources. This will usually be either from a Reading Section of some other sources.

Self-assessment exercises are interspersed throughout the units. Working through these practices will help you to achieve the objectives of the unit and prepare you for the assignments and examination. You should do each self-test exercise as you come to it in the study unit. There will also be numerous examples given in the study units, work through these when you come to them too.

The following is a practical strategy for working through the course. If you run into any trouble, telephone your tutor. Remember that your tutor's job is to assist you when you need help, therefore do not hesitate to call and ask your tutor to assist you.

- Read through this course guide thoroughly.
- Organise a study schedule. Refer to the course overview for more details. Note the time you are expected to spend on each unit and how the assignments relate to the units. Important information e.g. details of your tutorials, and the date of the first day of the semester will be made available through the study centre. You need to gather all these information in one place, such as your

diary or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working through each unit of the course.

- Once you have created your own schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their course work. If you get into difficulties with your schedule, please keep your tutor informed before it is too late for help.
- Turn to Unit 1 and read the introduction and the objectives for the unit.
- Assemble the study materials. Information about what you need for a unit is given in the "*introduction*" at the beginning of each unit.
- Working through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through the units, you will be instructed to read sections from your other sources. Use the unit to guide your reading.
- Well before the relevant due date, check your assignment file and make sure you attend to the next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the examination. Submit all assignment not later than the due date.
- Review the objectives for each study unit; confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.
- When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to face your study so that you keep yourself on schedule.
- When you have submitted an assignment to your tutor for marking, do not wait for its return before starting on the next unit. Keep to your schedule. When the assignment is returned, pay particular attention to your tutor's comments, both on the tutor-marked assignment form and also on the comments written on the assignment. Consult your tutor as soon as possible if you have questions or problems.

- After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives (listed at the beginning of each unit) and the course objectives (listed in the course guide).

## **FACILITATORS/TUTORS AND TUTORIALS**

There are tutorial hours provided by the National Open University of Nigeria (NOUN) in support of this course. You will be notified of the dates, time and location of these tutorials, together with the names and telephone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter and provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date. They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary.

### **Contact your Tutor if:**

- you do not understand any part of the study units or the assigned readings
- you have difficulty with the self-test or exercise
- you have a question or problem with an assignment you have a question with your tutor's comment on an assignment or with the grading of an assignment
- you should try your best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can sort out any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating actively in the discussions.

## **SUMMARY**

It is important you know that this course material was actually adapted from ICAN Study Pack. This provides you the opportunity of obtaining a degree in Accounting and preparation for your professional examinations. Therefore, it is very important that you commit adequate effort to the study of the course material, for maximum benefit. Good luck.




**MAIN  
COURSE**

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**MODULE 1      AUDIT PLANNING AND CONTROL**

|        |  |
|--------|--|
| Unit 1 | Audit Strategy                                     |
| Unit 2 | Audit Evidence, Test, Document and Risks           |
| Unit 3 | Organisation and Management of Professional Office |
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**UNIT 1      AUDIT STRATEGY****CONTENTS**

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**1.0      INTRODUCTION**

Auditing has developed over many years, but it was not until the late nineteenth century (with the formation of joint stock companies) that auditing became widely accepted in the United Kingdom and by extension, in other parts of the world. Individual firms of Accountants have refined their approach to auditing from time to time; and the professional accountancy bodies in various countries have published guidelines to their members on auditing procedures.

**2.0      OBJECTIVES**

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

- explain the concept of audit strategy
- outline what the auditor should do in carrying out an audit assignment
- explain the importance of audit strategy as an effective plan for an audit
- illustrate the points to be considered in audit planning
- state the points to be considered in audit planning memorandum
- discuss what the auditor should do to be familiar with the client's business and organisation.

### **3.0 MAIN CONTENT**

#### **3.1 Concept of Audit Strategy**

Audit strategy is directed at the gathering of relevant and reliable audit evidence in order to support the expression of an opinion on the accounts. In carrying out an audit assignment, the auditor should:

- (a) consider his responsibilities as defined in the terms of engagement;
- (b) familiarise himself with the client's business and organisation;
- (c) obtain a preliminary understanding of the principal features of the client's accounting system and internal control procedures;
- (d) determine and record the audit strategy to be adopted;
- (e) (where it is proposed to carry out a detailed evaluation of all or certain internal controls with a view to placing some reliance on such controls), obtain a more detailed description of the accounting system and internal control procedures and review selected transactions to confirm that he has understood and recorded the system properly;
- (f) review critically and evaluate those aspects of the client's accounting system, procedures and internal controls on which he intends to place some reliance;
- (g) discuss any weakness in the system with the client in order, *inter alia*, to ascertain whether they are compensated by some other controls;
- (h) test the system to determine whether the controls on which he intends to place reliance were operating during the period;
- (i) report apparent weakness and breakdown in internal control to the client in a management letter; and
- (j) based on the results of the work described above, carry out a programme of audit work to substantiate the amounts appearing in the accounts and related notes so as to ensure that the accounts show a true and fair view of the state of affairs and the results of the business.

The above summaries the basic procedures that, an auditor should carry out in order to express an opinion on the accounts. It should be noted, however, that the procedures and terminology used in practice may vary, even though; the fundamental concept may be the same. Furthermore, the extent to which the auditor places reliance on the work of an internal audit department may significantly affect the nature, timing and extent of his work.

## **SELF-ASSESSMENT EXERCISE**

What are the basic procedures that an auditor should carry out in order to express an opinion on the accounts?

### **3.2 Determination of the Audit Strategy Purpose**

The purpose of determining an audit strategy, is to enable the auditor familiarise himself with the client's business and organisation, as well as to obtain a preliminary understanding of the client's accounting system. This will entail the preliminary identification of those internal controls on which he proposes to rely upon.

The auditor should then determine and record his audit strategy before commencing any detailed audit work. In doing so, the auditor will need to identify the optimum balance between, on one hand, relying on internal controls and reducing the level of his substantiate tests, and on the other hand, placing little or no reliance on internal controls and seeking audit satisfaction from a higher level of validation procedures. The purpose of making this assessment is to enable the auditor to carry out the audit in the most effective and efficient manner. Determination of the audit strategy requires a high degree of professional judgment.

Consequently, the audit assignment should be carried out by an experienced staff, with the involvement of the audit partner. In particular, the determination of the audit strategy for a new client will usually require considerably more time and effort than for existing clients, except where the circumstances of existing clients have changed significantly since the last audit. However, this does not mean that a formal determination of the audit strategy is not necessary for existing clients whose circumstances do not change significantly from year to year. In all cases, a formal record of the audit strategy is essential. The overall strategy should focus on a more efficient and effective audit.

### **Audit Plans and Audit Planning Memorandum**

In order to ensure a high standard of performance, it is important that the auditor should prepare adequately for his work. Planning for an audit, just like every human endeavour, is essential for the smooth performance of the audit work and its successful completion. Planning ahead for an audit work will not only guarantee a valid audit opinion but will also help the auditor to ensure that:

- (a) the audit objective is established and achieved
- (b) the audit is properly controlled and adequately directed at all stages
- (c) high risk and critical areas of the engagement are not omitted but that adequate attention is focused on these areas; and
- (d) the work is completed economically and expeditiously, hence, savings on audit resources.

It is important to distinguish between an audit plan and an audit planning memorandum. Audit plan relates to preparations made by the auditor for one specific audit engagement. While audit planning memorandum, is a standing arrangement made by the auditor for the continuing engagement of a particular client. Hence, an audit plan is for the audit of one client for one year while audit planning memorandum is a standing plan for the continuing audit of a client from year to year.

### **Points for Consideration in Audit Planning**

Audit planning requires a high degree of discipline on the part of the auditor. In order to make the planning more meaningful, the auditor should take into consideration the following matters in relation to the audit engagement:

#### **(a) Preliminary Work to be Done in Addition to the Real Audit Work**

This will include such matters as stocktaking, cash count, debtors' circularisation and review of previous year's working papers. This will remind the auditor of those matters brought forward from the previous year and any other points to be resolved in the current year or problems anticipated.

#### **(b) Changes in Legislation or any Auditing Standards or Guidelines**

The promulgation of the Companies and Allied Matters Act, Cap. C 20, LFN 2004, brought with it a lot of changes in accounting and auditing requirements of companies. Such legislations whether in respect of all companies or particular industrial group, must be reviewed ahead of the engagement in order to determine their effects on the operations or reporting requirements of the enterprise.

**(c) Analytical Review of Available Management Accounts and Other Management Information that relate to the Accounts**

This will assist in establishing valuable ratios and indicators that will guide the auditor. For instance, the computation of the gross profit percentage compared with that of the previous year will provide a good indicator to the auditor of the accuracy and reliability of sales and cost of sales.

**(d) Changes in the Business or Management**

The appointment of a new Finance Controller and the establishment of a new business line or the creation of a new branch are significant changes in the circumstances of the company which will necessitate changes in the existing audit plans.

**(e) Changes in the Accounting System**

The introduction of computers such that when a company introduces significant changes in its operating procedures will require a review and evaluation of the system of internal control.

**(f) Deadlines Established for the Submission of Audit Report**

Where a client has set deadlines for its statutory activities such as the annual general meetings, it is important for the auditor to work in line with such programmes.

**(g) Use of Rotational Testing and Verification**

In practice, the auditor may not carry out a hundred per cent testing or verification of the client's transactions or segments of the business. Where rotational testing or verification is adopted, it will be necessary for the auditor to determine ahead of the date of the engagement which aspects of the business should be selected for testing or verification. An example of rotational testing could be applied on the client's branches to be visited.

**Points for Consideration in Audit Planning Memorandum**

Audit planning memorandum should cover the following standing matters which are designed to achieve the desired audit objectives:

**(a) Terms of Engagement**

In the case of a new audit engagement, a letter of engagement should be prepared as part of the overall plan of the audit. Even in subsequent visits, the letter of engagement should be reviewed in the light of current circumstances to ensure that all aspects of the work undertaken for the client are covered in the letter especially as they relate to taxation, accountancy, staff development and executive search.

**(b) Audit Risk Areas**

The auditor should critically review all the areas of high risk in order to ensure that the planned procedures adequately cover such areas and that competent staff have been assigned to these areas. High risk areas may relate to the nature of the items, such as cash for a retail establishment with numerous collection points and outdoor disbursement locations. Risk may also relate to a high probability of error as in the case of stocks whose quantities are subject to estimation and are susceptible to pilferage. The risk may also relate to the structure of the organisation, where the owners are not equally represented in the management. There is therefore the risk of withholding key information from some of the directors.

**(c) Assets and Liabilities**

These will require detailed plans since they are of continuing relevance to the financial statements of many years and the relevant vouchers may not be readily accessible. The plans relating to assets should clearly disclose their history such that current movements may easily be ascertained and adequately verified. These will apply mainly to plant and long term loans.

**(d) Presence of Internal Auditor**

Wherever an auditor exists in an organisation, the auditor should develop suitable plans to review the technical competence of the internal auditor, his degree of independence and scope and quality of his work in order to determine the extent of reliance to be placed on his work in order to identify the areas of work overlap.

**(e) The Need for Specialists**

The auditor should determine ahead of his visit those aspects of the work that may require the services of specialists. This may be internal or external specialists as relates to stocks, specialist valuation for insurance or computer applications.

**(f) Audit Approach**

Based on the review of the system of internal control, the auditor should be able to decide on the audit approach to adopt. This will be based on the extent of reliance to be placed on the system of internal control.

**(g) Timetable**

A critical aspect of the audit is the timetable. The auditor should establish plans to ensure that for each year, the audit is completed within any stated deadline for submission of the report.

**(h) Staffing**

The auditor should plan for adequate number of staff with the required skill for the audit. The training of audit staff is a long term process which will require that even from the initial appointment of the auditor; he should take steps to train suitable staff in sufficient number to handle the audit of the client.

**(i) Fees**

Based on plans already established in terms of time, staff and materials, the auditor should plan for his fees to cover staff salaries, overhead costs and leave a sufficient margin for the partners' share of profit and pension scheme. The planned fees must be discussed with the client, if not already agreed.

**Understanding the Client's Business**

The extent of the knowledge gained of the client's industry and business organisation greatly facilitates the performance of the engaged staff. It is essential therefore that all staff engaged in the audit is encouraged to gain an understanding of the client's business operations. Such understanding, in addition to enhancing the overall audit performance, also facilitates communication with client's staff –in terms of assessing the reliability of representations from management and making judgment regarding the appropriateness of the accounting policies adopted and their disclosure.

The auditor may obtain knowledge of the client's business in the following ways:

- (a) Personal visits to the client's premises and operating bases and holding discussions with key officials of the company;
- (b) Reading minutes of meetings and correspondence with the client;

- (c) Reading internal audit report;
- (d) Reading previous year's audit files and permanent audit files;
- (e) Reading other materials from within the firm, e.g. management consultancy reports and feasibility reports; and
- (f) Reading relevant materials relating to the business e.g. trade journals, investment analysis and stockbroker's report.

Other significant factors which should be considered by the auditor to determine the audit strategy are as follows:

- (a) The auditor's responsibilities in accordance with the terms of the engagement;
- (b) The nature of the client's business;
- (c) The nature and significance of items in the year's accounts; and
- (d) The principal features of the client's accounting system and the extent and effectiveness of the related internal accounting controls, which may be granted from preliminary understanding of the system.

Consideration of the above factors should enable the auditor determine an appropriate audit strategy which should be set out in writing, in an audit strategy memorandum, which should be approved by the audit partner.

However, the auditor should recognise that this strategy may, if necessary as a result of changing factors, be reviewed and revised as the audit progresses. For existing clients, the auditor should have much of the information he needs to determine his audit strategy in his audit files. Nevertheless, he should still discuss with the clients' management whether there have been any changes in the company's circumstances that might affect his audit approach.

The external auditor is appointed to carry out audit in accordance with specific regulatory or statutory requirements, such as the Companies and Allied Matters Act or in accordance with generally accepted auditing standards within the country concerned. In these circumstances, the terms and conditions will not call for any special consideration when determining the audit strategy. The auditor should, however, consider whether additional responsibilities arise from request by the client's management or because the client is required to conform to special regulatory or other requirements.

### **SELF-ASSESSMENT EXERCISE**

Planning ahead for an audit work will not only guarantee a valid audit opinion; but will also help the auditor to ensure what?

### 3.3 Familiarity with the Client's Business and Organisation

The auditor needs reasonable knowledge of both the business of the client and the industry in which the client operates, how and in what places its activities are carried on, in addition to the basic financial information which will be obtained for the audit in order to understand and interpret the financial statements on which he is reporting.

In order to familiarise himself with the business and organisation of a new client, the auditor would normally:

- (a) examine publications emanating from:
  - i. the client, such as annual reports or interim financial statements; and
  - ii. others, regarding the client's industry or business;
- (b) have meetings with the client's management, in order to identify the major types of transactions entered into by the client; and
- (c) examine the client's important internal documents, such as:
  - i. procedure manuals;
  - ii. legal documents i.e. memorandum and articles of association, contracts; lease and loan agreements;
  - iii. minutes of meetings of the Board/AGM (and/or any important Committees thereof);
  - iv. policy statements; and
  - v. internal management accounts.

The auditor should also tour the client's principal places of business, such as plants, factories, shop and offices. The auditor of a manufacturing concern, for instance should undertake a tour of the company's factory in order to familiarise himself with the production process, to see the types of scrap items and the manner of their disposal and the form of the finished products. In all other concerns, the auditor should make him or herself familiar with the market in which the business operates and with its methods of marketing.

Having adequate knowledge and background of the business will make the auditor to determine whether the system of accounting and internal control disclosed by his detailed review is appropriate for the business and properly records all its transactions. Such knowledge will also give the auditor an awareness of the physical realities behind the accounting records and financial statements which he examines and will enable him consider their significance more intelligently.

The auditor's task of familiarising himself with the client's business and organisation will often involve his spending additional time on the first

audit of a new client. In contrast, the need for him to spend additional time for this purpose on the audit for the second and subsequent years may be fairly limited, as he may only need to have brief meetings with key members of the client's staff to consider any changes in the client's circumstances and systems since the previous year.

However, the importance (to the auditor) of updating his knowledge and understanding of the client's system in this way, before carrying out any audit test, cannot be over-emphasised.

### **The Nature and Significance of Items in the Accounts**

Normally, the most important factor in the determination of the audit strategy will be a review of recent accounts and other available financial information in order to assess the relative significance of items appearing in the balance sheet and the profit and loss account.

The auditor should obtain information on the nature and approximate volume of transactions which result in significant account balances. The assessment will need to take into account any audit risks identified when analysing the client's business. Those account balances, which are considered to be insignificant, can be subjected thereafter to any limited audit procedures.

### **Preliminary Understanding of the System**

In order to evaluate the potential for reliance on internal control in respect of all significant items in the financial statements, the auditor should gain a preliminary understanding of the principal features of the client's accounting system giving rise to these items, together with the related internal control procedures. This involves a consideration of the methods of and control over, processing and the principal accounting records maintained for each significant transaction type.

This preliminary understanding and evaluation of the potential for reliance on internal control should be documented, normally by way of overview flow charts. However, this preliminary evaluation, which is made for the purpose of determining the audit strategy, should be distinguished from the detailed evaluation using the internal control questionnaire.

Nevertheless, apparent weakness in internal control, which comes to the auditor's attention in the course of the preliminary evaluation, should be brought to the client's attention. The record of the accounting system prepared for the purpose of determining the audit strategy may need to be supplemented by a more detailed description of the accounting system

if the auditor intends to carry out a detailed evaluation of internal controls. However, it should, generally, prove adequate for the purpose of planning and performing substantive tests.

During the course of the auditor's preliminary review of the accounting system and controls, he should be able to identify those items in the accounts which because of the limited volume of transactions or other factors, can be audited more efficiently through the application of substantive tests rather than reliance on internal controls. Examples of such account balances are share capital, long term debts and related interest expense, investments and related income (except when a large portfolio of investments is held). In a similar vein, he may decide to ignore internal controls entirely, either for reasons of efficiency or because the controls are not operating properly, and carry out extended validation for all balance sheet and profit and loss account items.

The auditor should identify any procedures the client applied to significant items in preparing the financial statements because they will influence the extent of the detailed evaluation of internal controls. Examples of such procedures are the counting of stocks, the reconciliation of bank balances and the establishment of provisions against doubtful debts.

### **Documentation of the Audit Strategy**

It will normally be desirable to document the audit strategy in a memorandum, which together with the necessary supporting documentation, should be prepared in the first year of an engagement and revised annually thereafter. The auditor can obtain information as to changes that may be required as a result of the experience gained from using the audit strategy adopted in the previous year.

The auditor may find it helpful to discuss the planned audit strategy with the client, for example, to inform him of a proposed reduction in the extent to which the audit will involve the evaluation of internal control procedures. In some cases, the client may wish such an evaluation to take place and the auditor will need to explain that, while he would be glad to comply, it is likely to have the effect of increasing cost.

The matters set out below are those which will normally be relevant and material in determining the audit approach and which should be addressed by the audit strategy memorandum. Other matters will almost certainly be relevant to particular audit clients and will need to be incorporated in the memorandum:

- (a) Whether the terms of the engagement vary from the requirements of the Companies and Allied Matters Act and approved auditing standards and guidelines;
- (b) Whether the report and accounts will include any supplementary information, and, if so, whether an audit opinion is to be given on it;
- (c) Particular risk factors or problem areas;
- (d) The number of accounting locations and the audit approach in respect of each, that is, whether to be covered by full audit or not to be visited with reasons for the decision. Where there are a number of accounting locations, certain elements of the strategy may have to be determined and recorded for each location;
- (e) Balance sheet amounts and those likely to be:
  - i. Insignificant; and
  - ii. Significant.
- (f) Types and volume of transactions that contribute to material balance sheet amounts;
- (g) Assessment of the potential for reliance on the internal controls over the transactions, in particular, whether the audit of significant items in the balance sheet are to be based:
  - i. Principally on reliance on internal controls with limited substantive tests; or
  - ii. Principally or entirely on substantive tests with reasons for the decision.
- (h) The control objectives to be evaluated (specifying whether a computer or manual will be adopted);
- (i) Any particular factor affecting levels of compliance tests expected to be performed, and whether any control that are to be evaluated are not to be subjected to compliance tests;
- (j) Whether a more detailed understanding of parts of the accounting system is required and how this should be recorded (flowcharts or narratives);
- (k) Assessment of the potential for reliance on operational controls;
- (l) The potentials, if any, for reliance on the work of internal audit;
- (m) The approximate levels of substantive test expected to be applied to each of the balance sheet accounts and the nature of any test requiring particular emphasis. For example, use of audit software;
- (n) An explanation of the approach to the audit of material profit and loss account items, including a brief description of any extended validation procedures to be adopted;

- (o) Where there is involvement by other auditors, that is, in the case of a group or a joint audit, the extent of liaison with the other auditors; and
- (p) Any other matters that the audit partner considers may affect the audit strategy, for example, operational matters.

### **Detailed Understanding and Recording of the System**

The extent to which the auditor should record the client's accounting system and the method adopted will depend on both the complexity and nature of the system and on the degree of reliance that he plans to place on internal controls.

Where the auditor plans to rely on internal controls, a permanent detailed record should be prepared of the accounting and internal control procedures in force, so as to facilitate the evaluation of controls and the preparation of a programme of audit tests. This recording may be done by means of flow charts, notes on accounting procedures or an internal control questionnaire.

This record is made in order to provide the information on which the evaluation of internal control will be based. It also enables members of the auditor's staff who have no previous experience of the company's affairs, and those engaged on the audit in future years, to familiarise themselves with the system of accounting and internal control in force. After he has prepared or updated the flow charts, and before doing any other audit work, the auditor should each year trace a transaction through the accounting system to confirm that the system has been properly understood and recorded. This is known as transaction review or walk-through test.

### **Evaluation of Internal Control**

#### **(a) General**

The auditor must satisfy himself that the underlying books and records can be relied upon as the preparation of the financial statements, which he is auditing. The auditor should therefore make a critical review of the system of book keeping, accounting and internal control. Those internal controls that are relevant to the expression of an audit opinion on the financial statements were defined as internal accounting controls, which comprise basic controls and discipline over the former.

The evaluation of a client's system of internal control enables the auditor to determine whether the system of internal control enables the auditor to determine whether the system contains control, which if they

can be demonstrated to operate during the period, would affect the nature, extent and timing of his audit procedures.

The extent to which the auditor chooses to rely on the operation of internal controls in any area will be partly governed by the relative efficiency of tests to confirm the operation of internal controls in any area will be partly governed by the relative efficiency of tests to confirm the operation of internal control procedures as opposed to extended validation procedures. It will also be governed by the extent to which the auditor finds the control to be operating effectively.

The effectiveness of the disciplines over basic controls will determine the auditor's ability to rely on the confirming operation of the basic controls and the extent to which it is necessary to carry out tests of the basic control by themselves.

**Basic Controls** - the basic controls are those controls built into the system and which operate all the time and in respect of all transactions. Typical examples are the pre-numbering of documents, the establishment of control or batch totals and the routine reconciliation of the subsidiary records with the control totals.

**Disciplines over Basic Controls** - disciplines over basic controls are those controls that are established as a check over the basic controls and which operate only occasionally or as often as management may desire. Typical examples of disciplines over basic controls are management supervision and routine stock checks.

The techniques employed to record and evaluate the system of accounting and internal controls are usually one or more of the following:

- i. The use of narrative, with an aide memoire or checklist;
- ii. The use of flow charts; and
- iii. The completion of an internal control questionnaire that includes questions designed to establish what the system is, as well as questions relating to the evaluation of the relevant controls, the first two being to record the system while the third is to evaluate the effectiveness of the system.

The actual technique used depends in part on the complexity of the client's accounting system.

**(b) Management Letter**

After the auditor has completed his evaluation of the internal controls and the tests to confirm whether the relevant internal control procedures are operating, he should report to the client on any internal control deficiencies that have come to his attention and on any other matters (of an operational nature) which he considers relevant at this stage. If additional matters come to his attention later as a result of applying substantive tests, these should be reported to the client at that stage.

**SELF-ASSESSMENT EXERCISE**

In order for an auditor to familiarise himself with the business and organisation of a new client, what should he do?

**4.0 CONCLUSION**

An understanding of the procedures and controls comprising a client's accounting system is the essential basis for determining the audit procedures to be applied. This understanding is normally obtained by discussions with the client's staff. As indicated in auditing standard (the auditors operational standard), such an understanding is necessary to enable the auditor assess the adequacy of the client's accounting system as a basis for the preparation of its financial statements.

Audit strategy is essential in every audit process as this reduces audit time and invariably the audit cost. However, the strategy to adopt is dependent on the auditor's assessment and evaluation of the client's internal control system in operation.

**5.0 SUMMARY**

In this unit, you have been exposed to the general concepts of audit strategy, determination of the audit strategy and familiarisation with the client's business and organisation.

**6.0 TUTOR-MARKED ASSIGNMENT**

1. Describe the basic steps to be taken by an auditor in order to express an opinion on client's financial statements.
2. Discuss the factors to be considered by the auditor in order to determine an audit strategy.
3. Discuss the need for the auditor to familiarise himself with the client's business.
4. Discuss the need for audit strategy documentation.

## 7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountants of Nigeria. (2004). *Advance Audit and Assurance*. Lagos: ICAN.

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## **UNIT 2     AUDIT EVIDENCE, TEST, DOCUMENT AND RISKS**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Audit Evidence
  - 3.2 Audit Tests
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- 4.0 Conclusion
- 5.0 Summary
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- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing audit evidence, audit test, audit document and audit risks.

### **2.0 OBJECTIVES**

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

- explain audit evidence
- outline the various types of audit test and procedures
- describe the use of working papers by the auditor
- discuss the quality of good audit working papers
- state the content of audit working papers and the factors that can minimise audit risks.

### **3.0 MAIN CONTENT**

#### **3.1 Audit Evidence**

The auditor's operational standard states that the auditor should obtain relevant and reliable audit evidence sufficient to enable him draw reasonable conclusions there from. The Auditing Guidelines on Audit Evidence gives guidelines on what constitutes adequate audit evidence. Audit evidence is information, written or oral, obtained by the auditor to support the conclusions on which he bases his opinion on the financial statements. Sources of audit evidence include the client's accounting system, and underlying documentation, tangible assets, management and

other employees, customers supplier's and other third parties who have dealings with, or knowledge of, the client's business.

The sources and amount of evidence needed to achieve the required level of assurance is a matter of judgment to be exercised by the auditor. He will however, be influenced by the materiality of the matter being examined, the relevance and reliability of evidence available from each source and the cost and time involved in obtaining it. Often, the auditor will obtain evidence from several sources, which together, will provide him with the necessary assurance.

The auditor can rarely be certain that the accounts on which he is reporting show a true and fair view. However, he needs to obtain relevant, reliable and sufficient evidence as a basis for his opinion on any matters relating to the financial statements. The auditor's judgment as to what constitutes relevant reliable and sufficient audit evidence is influenced by such factors as:

- (a) his knowledge of the client's business and the industry in which it operates; and
- (b) the degree of risk of misstatement through errors or irregularities, this risk may be affected by such factor as:
  - i. the nature and materiality of the items in the financial statements
  - ii. the auditor's experience as to the reliability of the client's management and staff and of its records
  - iii. the financial position of the clients
  - iv. possible management bias; and
  - v. Persuasiveness of the evidence.

The relevance of the audit evidence should be considered in relation to the usual audit objective of forming an opinion and reporting on the accounts. The liability of audit evidence is dependent upon the particular circumstance. However, the following general assumptions may be found helpful:

- (a) Documentary evidence is likely to be more reliable than oral evidence;
- (b) Evidence obtained from independence sources is more likely to be reliable than that secured from the client; and
- (c) Evidence originated by the auditor from his analytical reviews and physical inspection is more reliable than evidence obtained from others.

The auditor should consider whether the conclusions drawn from different types of evidence are consistent with one another. When audit evidence obtained from one source is in conflict with that obtained from another, the reliability of such remains in doubt. Additional evidence will be needed to resolve the consistency. However, when the individual items of evidence relating to a particular matter are all consistent, then the auditor has obtained a cumulative degree of assurance higher than that which he obtains from the individual items. This is on the basis of the principle of synergy.

### **SELF-ASSESSMENT EXERCISE**

The auditor's judgment as to what constitutes relevant, reliable and sufficient audit evidence is influenced by what?

## **3.2 Audit Tests**

### **(a) Types of Tests**

Audit tests are referred to in practice by a variety of names. Generally, audit tests can be divided into two types- compliance and substantive tests:

- i. Compliance tests are those designed to provide evidence as to whether the internal control procedures are being operated as planned; and
- ii. Substantive tests are those designed to substantiate the validity, accuracy and completeness of amounts appearing in the financial statements and related notes.

### **Test the Operation of Internal Control Procedures (Compliance Test)**

Internal control procedures are tested in order to provide reasonable assurance as to the proper operation of those accounting controls upon which the auditor may rely when determining the nature, extent and timing of his substantiate tests. If the auditor can satisfy himself that the basic controls over an accounting operation have continued to operate satisfactorily throughout the period under review, that is, the disciplines over the basic controls are effective, he may reasonably:

- (a) reduce the level of the related substantive test; and
- (b) carry out some of them as at dates other than the end of the accounting period.

The auditor may sometimes find the disciplines over the basic controls are either not effective or absent in some areas, and he may not be able to carry out some of his substantive testing procedures before the end of the accounting period, because he will not have been able to satisfy himself as to the continued operation of the basic controls throughout the period under review. In such circumstance, the auditor may either have to increase the level of his tests over the basic controls or it may be appropriate for him not to test the internal control procedure but to perform instead extended validation procedures if this results in a more efficient audit.

### **Substantive Testing Procedures**

Substantive testing procedures represent the final stage of the audit leading to the expression of an audit opinion. They comprise direct tests of account balances and other information contained in the financial statements and other procedures of a more general nature that indirectly provide evidence of the validity of the amounts appearing in the financial statements, referred to as “other auditing procedures”.

Examples of such other auditing procedures are:

- (a) Analysis of fluctuations in account balances; and
- (b) Analysis of financial trends and ratios involving the review of the financial position and performance of the client as expressed by significant performance indicators, such as, gross profit percentage, ratio of debtors, stock and various expenses to sales.

The nature, extent and timing of substantive testing procedures, are dependent on the reliance that the auditor can place on the internal controls. Where he cannot, or prefers, in the interest of a more efficient audit, not to rely on them for the purpose of limiting his substantive tests, it will be necessary for him to perform extended validation procedures. Depending on the nature of the identified internal control weaknesses, this will involve:

- (a) going to a greater depth in the procedure already contemplated, that is, seeking more complete documentary evidence in support of payment made;
- (b) performing additional procedures not otherwise contemplated. For example, by confirming accounts payable with suppliers in case where this would not otherwise have been done; and
- (c) performing more tests of the nature already contemplated, such as, by verifying a greater proportion of the items making up an account balance or, in verifying completeness of recording, by checking either a greater number of items or for a longer period of time.

In particular, it may be decided in the light of the evaluation of internal control not to carry out tests on the internal controls over transactions but to carry out extended validation procedures on income and expenditure accounts by means of an examination of large number of transactions, in order to verify the reliability of the accounting records.

### **SELF-ASSESSMENT EXERCISE**

What is the difference between compliance test and substantive test?

## **3.3 Audit Documentation**

### **Audit Working Papers**

A working paper is any document or record containing a report, correspondence and any other information that an auditor collects or any record which the auditor produces in the course of the audit procedures to discharge his professional duty to clients. An audit is erroneously regarded as a process by which the auditor piles up papers or heaps of books. However, the more paper the auditor amasses, the better the audit he has done.

Standards on Audit Documentation are- Nigerian Standards on Auditing (NSA 4- Documentation) and the International Standards on Auditing (ISA 230 – Documentation)

The NSA states that:

- (a) The auditor should document matters which are important in providing audit evidence to support the auditor's opinion and evidence that the work was carried out in accordance with NSAs.
- (b) The auditor should prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the e-audit.
- (c) The auditors should record in the working papers information on planning the audit, the nature, timing and extent of the audit procedures performed and the results thereof, and the conclusions draw from the audit evidence obtained.

The extent of working papers which the auditor produces or obtains is a matter of professional judgment since it is neither necessary nor practical to document every matter the auditor considers. In assessing the extent of working papers to be prepared or retained, it may be used for the auditor to consider what would be necessary to provide another auditor who has no previous experience of the audit work with an understanding of the work performed and the basis of the principal decisions taken but not the detailed aspects of the audit.

From the above, it can therefore, be inferred that the main objective of the auditor's working papers is to record and demonstrate the steps which have been taken by the auditor to enable him form an independent opinion on the financial statements upon which they are required to report.

Therefore, in order to achieve this objective, audit working papers should provide:

- (a) Information about the organisation being audited, including its recent history;
- (b) Evidence of work done in the course of the audit;
- (c) A means of controlling the current year's audit; and
- (d) Schedules in support of the accounts audited and summaries of the client's books.

### **Reasons or Advantages for Preparing Audit Working Papers**

In general terms, the listed benefits below can be derived from well-drawn up and properly organized audit working papers:

- (a) To ensure that the audit work is conducted methodically and systematically. Without properly organised working papers, the auditor can rarely maintain a perfect grasp of the work he carries out in which case the audit cannot be carried out in an orderly manner.
- (b) To provide continuity in the case of audit staff leaving midway through the audit engagement. Experience has shown that audit staff may resign his employment even before a particular audit is concluded. Without working papers, it will not be possible to know which aspects of the work have been completed; hence the audit may have to be recommenced from the start.
- (c) To enable an independent review of the audit work. The person who carries out the review of the audit work does not need to be present when the audit exercise is carried out. With the relevant working papers, he can carry out an effective review of the audit work.
- (d) To provide support for the audit opinion expressed. The opinion expressed by the auditor in his report is based on the work he carried out and this can only be meaningful if documented on working papers.
- (e) To provide supporting details for all items appearing in summary in the published balance sheet and the profit and loss account. Working papers provide greater detail and meaning to items which appear in summary on financial statements.

- (f) To provide a permanent record of tests and procedures carried out. Working papers are a lasting record of the detailed work carried out by the auditor and which would have been easily lost if not documented on working papers.
- (g) To provide a guide for the planning of future audits. For subsequent audit engagements, the auditor may refer to previous working papers as a guide of the procedure to be carried out.
- (h) May be used as evidence in the event of litigation against the auditor. Working papers are valid documents which the auditor may need to present as evidence of the work he has carried out in the event of litigation.
- (i) To confirm that all aspects of the work have been completed. Working papers serves as effective checklist that all aspects of the work have been carried out.

The published financial statements of a company comprise only classified and suitably summarised items reported on a few pages of the annual report. Audit working papers provide greater details of these items hence, helping to explain the meaning and the origin of the component transactions. Audit work cannot be based on intuition; rather it is on rational, articulate and ordered thinking on the part of the auditor. Without keeping a record of the procedures carried out or to be undertaken, the auditor is unable to maintain a perfect grasp of the work. The auditor's memory is likely to fail without a well-ordered record of the work he has performed or intends to perform.

### **Qualities of Good Audit Working Papers**

No standard format is advocated for audit working papers. It is however, important to ensure that working papers not only conform to the requirements of a particular firm but also satisfy the requirements of an independent reader. The following guidelines should be observed when writing up working papers:

- (a) Each working paper should be clearly headed with the client's name, the subject matter of the working paper, the date of the engagement, the initials of staff preparing the working paper and the date;
- (b) As far as possible, working papers should be prepared on standard stationery;
- (c) Details of work done must be clearly shown as to leave no doubt in the minds of readers;
- (d) Questions asked, answers received, observations made, queries raised, replies received and conclusions reached should be clearly stated;

- (e) Completed working papers should be serially numbered and suitably arranged in the audit files;
- (f) Points carried forward and the subsequent disposal of such points must be clearly stated on the working paper;
- (g) Each working paper must bear the signature/initials of the manager or partner who reviewed it; and
- (h) Each working paper should be suitably cross-referenced to the related parts of the audit file.

### **Contents of Audit Working Papers**

Audit working papers are usually arranged in two files according to their contents, namely, the current audit file and the permanent audit file.

#### **(a) The Current Audit File**

This file contains information relevant to the year under consideration and it is based on the contents of this file, that the auditors form opinion on the client's financial statements.

The current file typically contains the following documents:

- i. A copy of the financial statements being audited and the trial balance;
- ii. The audit programme, which will contain the list of audit work to be done and the list of audit tests to perform;
- iii. Schedules of major items in the profit and loss accounts and the balance sheet;
- iv. List of audit queries and their dispositions;
- v. List of matters requiring the engagement audit partner's attention;
- vi. Extracts of minutes of meetings of the board and management;
- vii. A description of the internal control systems in operation;
- viii. Letters of representations from management;
- ix. Checklists for compliance with statutory disclosure requirements and accounting standards; and
- x. Management letter setting out internal control weaknesses in the system to the client.

#### **(b) The Permanent Audit File**

This file contains information of continuing importance, which will be required for more than one audit. With the contents of this file, the auditors will have a better understanding of the client's operations and business. The file will also typically contain the following information:

- i. A brief history of the business as to the nature of business, major competitors, major sources of revenue and operating industry;
- ii. List of major accounting policies;
- iii. Copies of statutes and regulations governing the entity's accounts and audit;
- iv. Names and addresses of the company's directors including details of service contracts with them; and
- v. The memorandum and articles of association of the business;
- vi. Copies of documents of continuing importance and relevance, such as legal Mortgages and Debenture deeds;
- vii. An organisational chart of the business showing names of responsible officials and lines of reporting;
- viii. Addresses of the registered office and all other premises, with a short description of the work carried on at each;
- ix. Names and addresses of the company's subsidiaries and associated companies; and
- x. List of books, other records and where they are kept.

### **Working Paper Standardisation**

Standardisation of working papers means the adoption of working papers, which can be used on all audits. The use of standardised audit working papers may improve the efficiency with which they are prepared and reviewed.

The standardisation of audit working papers has the following advantages:

- (a) Staff become familiar with them;
- (b) It improves efficiency;
- (c) Matters are not overlooked;
- (d) They help to instruct audit staff;
- (e) Work can be delegated to lower level staff; and
- (f) Work can be controlled and reviewed much more easily.

However, despite the benefits of standardising the routine documentation of audit work, the system has following drawbacks:

- i. Initiative may be stifled;
- ii. Audit work becomes mechanical; and
- iii. It reduces the exercise of professional judgment.

## **Ownership of Working Papers**

From the definition of working papers, working papers not being the end product that the client needs, belong to the auditor. It is important to distinguish between working papers and the client's books and records. In principle, the books and records of the business given to the auditors to examine and from which they compile their working papers belong to the client.

However, where the auditor is being owed for his professional services, he can exercise a lien over the client's books and records and not on his working papers that belong to him ordinarily. In *WOODWORTH vs. CONROY* (1976), it was held that auditors do not have a general right of lien but a particular right of lien. A general lien is exercisable over all the books and records of a client where the debt owed is not traceable to a particular book or record. A particular lien is exercisable over a specific book or record that the debt can be traced to.

In order to exercise the particular right of lien, the courts are of the opinion that the following conditions must be satisfied:

- (a) The books and records must belong to the debtor client and not a third party no matter how closely associated or connected with the debtor client;
- (b) The accountant must have obtained possession by proper means;
- (c) Work has been done on the books and records; and
- (d) The debt for which the lien is exercised must be in respect of work done on the books and records and not on other books and records belonging to the same clients.

## **Retention of Audit Working Papers**

It is a general principle that working papers should be retained for as long a period as possible. In respect of audit, the working papers should be retained for a minimum period of six years.

## **Expert Evidence**

### **(a) Introduction**

The Nigerian Standard on auditing (NSA) 27, on "Using the Work of an Expert", defines expert as a firm or person possessing special skill, knowledge or experience in a particular field other than accounting or auditing. Though the auditor's education and experience make the auditor generally knowledgeable in business matters, but he/she is not

expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.

For instance, an accountant is not expected to possess the specialist skills of a medical doctor, engineer, pharmacist or actuary. During the course of an audit, the auditor may need to use audit evidence in the form of statistical data, reports, opinions, valuations or statement from experts such as valuers, engineers, architects, actuaries, geologies, lawyers, stockbrokers or quantity surveyors.

Circumstances in which the work and report of such experts may be used include the following:

- i. Valuations of certain types of fixed assets including land and buildings, plant and machinery, works of art and antiques;
- ii. The measurement of work done or to be done on long term contracts for the purpose of revenue recognition;
- iii. Valuation of certain types of stocks and consumable materials including the determination of their quantity, conditions and composition, for example, jewellery and other precious stones and chemicals;
- iv. Geological determination of mineral and petroleum reserves and the characteristics of those reserves;
- v. The legal interpretation of agreements, statutes and regulations;
- vi. Legal opinion on the outcomes of disputes and litigations;
- vii. Actuarial advice for the purpose of assessing the cost of pension provision; and
- viii. Actuarial determination for the purpose of assessing the technical reserves of a life insurer.

When the auditor uses the work of an expert employed by the firm, the auditor will be able to rely on the other firm's systems for recruitment and training to determine that expert's capabilities and competence.

### **Reliance on Experts**

When determining the need to use the work of an expert in the course of his audit, the auditor should consider the following factors:

- i. The materiality to the items being examined in relation to the financial statements;
- ii. The nature and complexity of the items including the risk;
- iii. Whether there are alternative sources of audit evidence;
- iv. Whether the work or report of the expert is readily available. For example, in the construction industry, regular site valuation

- reports by quantity surveyors are prepared and this can be made readily available to the auditor at no additional cost;
- v. The cost and time involved in obtaining evidence from the expert balanced against the benefit of obtaining evidence from this source; and
  - vi. The reputation, qualification, competence and objectivity of the particular expert concerned.

It is pertinent to note that though the auditor may rely on the work of an expert and reduce the extent of his work, the ultimate responsibility to report on the truth and fairness of a client's financial statement is that of the auditor alone and cannot be reduced or affected by this reliance.

### **SELF-ASSESSMENT EXERCISE**

What are the benefits to be derived from well-drawn up and properly organised audit working papers?

### **3.4 Audit Risks**

Audit risk is the term given to the risk that the auditor will reach an invalid opinion or conclusion from his audit work. Although some level of risk will have to be accepted, in practice, a firm will need to quantify its acceptable level of audit risk.

At the planning stage, the auditor should assess the risk of material errors or misstatements in the following areas;

- (a) In the financial statements as a whole; and
- (b) In each of the component items in the financial statements, such as cash, stocks, debtors, creditors and (in the balance sheet) and sales, expenses and purchases (in the profit and loss account).

This assessment will be kept under constant review as the audit progresses. Since material errors could arise intentionally or unintentionally, the auditor needs to be alert to all circumstances in which the errors could arise. Material misstatements may of course arise from irregularities including fraud. The Auditing Practice Committee's operational guideline titled "The Auditor's responsibility for detecting and reporting fraud and other illegal acts" states that in assessing the risk of material irregularity, the auditor may wish to consider the following areas:

**(a) Business Environment**

- i. Nature of business, its services and its products. For example, a company that mainly receives cash for its sales will have its income (cash) readily susceptible to misappropriation;
- ii. Circumstances which may exert undue influence on management;
- iii. Accounting methods;
- iv. Transactions with related parties;
- v. Company performance, for example, the deliberate distortion of financial statements to meet a profit forecast; and
- vi. Management integrity. This includes conduct aimed at evading tax liabilities.

**(b) Control Environment**

- i. Skill, integrity and effectiveness of management;
- ii. Competence of control personnel;
- iii. Internal control system in operation within the enterprise;
- iv. Existence and effectiveness of internal audit function;
- v. Unusual transactions;
- vi. The recruitment and training of staff;
- vii. Complex corporate structure;
- viii. Management's overall control, that is, the extent of supervision; and
- ix. Excessive authority vested in as senior staff.

In reaching his decision as to the areas to be tested and the number of balances and transactions to be examined, the auditor will need to consider information available from prior experience and his knowledge of the client's operations.

The procedures adopted by the auditor for the purpose of detecting material errors and irregularities in conducting an audit, will depend on his judgment as to:

- (a) The extent to directly relevant legislation;
- (b) The relative effectiveness of different audit tests;
- (c) The risk that a particular type of irregularity, error or breach of directly relevant legislation could impair the true and fair view of the financial statements; and
- (d) The risk that such irregularity can occur and remain undetected by the company.

### **Determination of Audit Risk**

A firm's audit risk is derived from an assessment of the following elements:

- (a) Inherent risk: This is derived from the characteristics of the client's products or services it deals in. It derives from the type of industry in which the client operates and will vary according to the accounts item being examined;
- (b) Control risk: This is the risk that the internal control system may not prevent or detect material misstatements or errors; and
- (c) Detection risk: This is the risk that the auditor's substantive audit tests and procedures and his review of the financial statements will not detect material misstatements or errors.

Audit risk, therefore, is the product of the above stated risks-  
(AR = IR x CR x DR) where:

AR = Audit Risk

IR = Inherent Risk

CR = Control Risk

DR = Detection Risk

Therefore, it is advisable to identify, assess and estimate or calculate audit risk in any given scenario.

### **Example of Audit Risk Estimation**

Suppose the inherent risk of material misstatement of the capital expenditure total is 70% (meaning that there is a 70% chance of an error occurring); but that the internal control system is strong and the non-detection by controls (control risk) is low- as in, 20% that it will not be detected.

At this stage, we can say that the risk is 14% (70% x 20%). We can now say that there is a 14% risk that material misstatements or errors in capital expenditure will occur and the internal controls will not detect it.

The auditor will usually consider that an overall audit risk of about 5% for any item in the financial statements will be considered appropriate and acceptable.

Thus, in this case, the auditor must consider the risk that any of his proposed audit tests and procedures will not detect the material misstatement. Suppose the detection risk is 30% (there is a 30% chance that the misstatement will not be detected by the audit tests), then the

overall audit risk is 4.2% (70% x 20% x 30%) and this is considered acceptable.

If the audit risk turns out to be unacceptable, then the auditor has to plan and execute further substantive test procedures. However, the auditor may still need to perform additional audit work where he is put on enquiry, even if the audit risk level is perceived acceptable.

In assessing the level of audit risk of a company, the auditors should bear the following factors in mind:

**(a) Inherent Risk**

- i. The company's performance and profitability;
- ii. The nature of the business, its services and the susceptibility of its products or services to market forces;
- iii. The financial stability of the company at present time and in the foreseeable future;
- iv. The incidence of related party and unusual transactions;
- v. The susceptibility of the company's assets to fraud and misappropriation;
- vi. The auditors previous experience with the company as regards the records reliability and the explanations given by the management;
- vii. Circumstances that may exert undue influence upon the company's management. For example, the pressure to meet budgeted profits; and
- viii. The likelihood that error could have a material effect upon the financial statements.

**(b) Control Risk**

- i. The strength, quality and effectiveness of its management;
- ii. Whether the company has an effective internal audit department;
- iii. The internal controls of the company and the competence of the accounting personnel;
- iv. The degree of supervision exercised by the management of the company; and
- v. The nature of the accounting methods in operation. For example manual or computerised records.

**(c) Detection Risk**

- i. Recruitment procedures of the audit firm;
- ii. Use of latest audit technique and procedures;

- iii. The qualifications, experience and competence of the engagement team; and
- iv. The method and timing of the audit review procedure.

### **Benefits of Audit Risk Assessment**

The benefits of audit risk assessment are:

- (a) It saves audit cost and fees;
- (b) It ensures that the audit work is completed expeditiously and economically;
- (c) It removes all avoidable pitfalls in the audit procedure;
- (d) It reduces the possibility of under or over auditing;
- (e) It results in a more effective and efficient audit work;
- (f) It focuses the auditor's attention on factors which are more likely to result in misstatement; and
- (g) It facilitates the use of sampling and the attendant benefits derived there from.

### **Limitations of Audit Assessment**

The limitations of audit assessment include the following:

- (a) Subjective values have to be placed on inherent and control risk;
- (b) It may result in a mechanical approach which leads to a loss of auditor's judgment;
- (c) The auditor may spend more time on the mechanic of the process and assessment at the expense of time spent obtaining audit evidence; and
- (d) The assignments of risk levels are often not suitably specific which puts into question the validity of any conclusions reached.

### **Factors that can Minimise Audit Risks**

Audit risk may be reduced if some of the following "positive" factors are identified:

- (a) The enterprise is financially stable without excessive debts, and is likely to remain so in the foreseeable future;
- (b) The enterprise is profitable, if its objective is to make profit;
- (c) The proprietor, in the case of a private company plays active role in the business;
- (d) The internal controls are strong and the company's accounting personnel are competent;
- (e) The past audit experience has provided evidence of good accounting controls with no major audit problems; and

- (f) The enterprise's relationship with the regulatory authorities has been good.

### **Audit Risk Evaluation**

Evaluating audit risk helps to identify which types of error and irregularity are most likely to occur. The audit work can then be planned to investigate particular risk areas thoroughly.

Audit risk should be evaluated and documented in the audit plan. Some firms have already developed comprehensive risk questionnaire which interrogate the client's financial and management environment in considerable detail.

It is imperative to emphasise that a perfect audit does not exist and it is almost inevitable that the auditor will find errors during the course of the audit and be faced with the decision as to whether these errors are material. He must decide whether the error would influence the financial statements users if it were known to them, and at the same time determine whether the error is indicative of other errors, which in turn, might expose him to greater audit risk.

A material error could through non-disclosure misstatement or omission of an item. Errors will normally be thought of in terms of monetary amounts. In these cases, the auditor should consider the amount in relation to the general view given by the financial statements, the total of which the amount forms a part, associated totals and previous years' figures. However, material error can occur if the information in the financial statements is not presented and described properly. In addition, the auditor may find that there are several errors, which may be considered individually to be immaterial but collectively may have a significant effect on the financial statements.

However, there are no specific guidelines as to how materiality decisions are made, as materiality is essentially a matter of judgment. In the final analysis it is the duty of the auditor to determine how his assessment of the risk will affect the audit and whether he could issue a clean audit report or not based on his assessment.

### **SELF-ASSESSMENT EXERCISE**

Outline the content of a business and control environment.

## 4.0 CONCLUSION

Documentation of the audit as evidence of work done is important by compiling good quality audit working papers. Aside from gathering evidence within the client's operating environment, the auditor may also look for evidence elsewhere by making contacts with experts.

Audit risk assessment is an important aspect of audit; the result will determine the nature, extent and timing of the auditor's substantive audit test programme. Where the assessment shows that the risk is high, the auditor is expected to pay particular attention to the transaction caption and design detailed level of substantive test programme. In carrying out the assessment, the auditor is expected to take into consideration the client's operating environment and the controls in operation.

The auditor is also expected to employ latest and good auditing tests, procedures and techniques so as to limit the possibilities of audit errors and wrong conclusion.

## 5.0 SUMMARY

In this unit, we discussed audit evidence, audit tests, audit documentation and audit risks.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. What is audit evidence?
2. Discuss the various types of audit tests.
3. What are the reasons for compiling audit working papers?

## 7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountants of Nigeria. (2004). *Advance Audit and Assurance*. Lagos: ICAN.

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## **UNIT 3 ORGANISATION AND MANAGEMENT OF PROFESSIONAL OFFICE**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Office and Office Facilities
  - 3.2 Partners' Relationship
  - 3.3 Staff Management
  - 3.4 Quality Control
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
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### **1.0 INTRODUCTION**

Audit firms are generally of three types, namely:

- (a) Small firms, which include sole practitioners and partnerships with two or three partners and constitute the most common type of audit firms.
- (b) Medium sized firms, bigger than the small firms but not as big as the “Big Four” networks. Some of the medium-sized firms have international cooperation with other firms.
- (c) The “Big Four” firms consist of the very big international firms, largest by fee income and have global affiliations. They were previously six till 1998 when the merger of Coopers & Lybrand with Price Waterhouse reduced this category of firms to five; and subsequently in 2002, the merger of Andersons with Deloitte and Touches Following the Enron saga later reduced them to four.

Most of the issues discussed in this unit are applicable to all the types of audit firms except for partners' relationships which are not applicable to sole practitioners. The scope of operations and the type of clients may also vary across the types of audit firms. For example, multinational corporations may find it easier to appoint any of the “Big Four” as their auditors.

## 2.0 OBJECTIVES

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

- describe an office and its facilities
- state what the partnership deed should cover
- state the various aspects of quality control in an audit firm.

## 3.0 MAIN CONTENT

### 3.1 Office and Office Facilities

Audit firms render services to their clients. They are service organisations and inevitably spend a greater proportion of the working hours at client's premises. Their offices should, however, be well located and the layout of the office should be professional in outlook. The environment must be neat and conducive for professional work. Decisions for office-based operations traditionally involve placing people who must interact near one another. Therefore, office space in audit firms should be apportioned according to the various services rendered to clients. These will include:

- (a) Audit/Assurance services- usually, this is divided into industrial sub-group like manufacturing, financial, energy and public in order to ensure efficiency and high quality;
- (b) Taxation services;
- (c) Management consultancy services;
- (d) Insolvency services; and
- (e) Corporate advisory services, other than the preparation of documents for public use.

Each of the sections should be well arranged and have clearly demarcated offices for the sectional staff. Responsibilities and reporting procedures should be clearly defined for the partners, managers, supervisors and trainees. In view of the fact that the key input for all service operations is human resources, audit firms should endeavour to provide office space that are conducive for their staff.

Other inputs for service operations include the facility where the service is provided, any material or equipment needed in providing the service, together with the relevant technology that makes the service provider more effective and efficient. Audit firms should therefore provide adequate facilities for the staff offices as well as those items that are required for use in clients' offices taking into consideration developments in modern technology. The following essential facilities should be provided for various grades of professional staff:

- (a) Laptops for all audit seniors and above;
- (b) Local area network to aid intranet connectivity;
- (c) Stand-by generator;
- (d) Calculators; and
- (e) Standard printed stationery such as bank confirmation letters, circularisation letters, audit programme, etc.

Audit firms should take into consideration the negative impact that a poorly located and badly designed office can have on their image.

### **SELF-ASSESSMENT EXERCISE**

Office space in audit firms should be apportioned according to the various services rendered to clients. Outline these services.

## **3.2 Partners' Relationship**

There are many advantages of partnership type of business over sole proprietorship. These advantages are also applicable in the case of audit firms. The following advantages of large firms over small ones are, clearly, distinguishable:

- (a) The growth of the firm is quicker;
- (b) Liabilities are shared among the partners;
- (c) Responsibilities are also shared by the partners;
- (d) The partners can specialise and become versatile in some specific areas of service; and
- (e) The partners' specialist areas complement one another.

An audit firm, like any other partnership, remains a business entity and must be run as such. There is, therefore, the need for the relationship among the partners to be regulated by a written agreement, which is often referred to as a "Partnership deed". This document contains the rights and privileges of the partners, bearing in mind that a partnership is a contract of utmost good faith. The partnership deed should cover such issues as:

- (a) Profit sharing ratio;
- (b) Salaries, if any;
- (c) Interest on capital;
- (d) Admission of a new partner;
- (e) Resignation, retirement or death of a partner;
- (f) Operation of the partnership account
- (g) Arbitration clause for conflict resolution;
- (h) Different categories of partners, that is, salaried, profit sharing, or sleeping; and
- (i) Dissolution of the partnership.

Partners should demonstrate among themselves their commitment to the growth and survival of the firm. Each of them should appreciate the need to have in place a system of effective management, which is one way of ensuring that the firm, through them, can:

- (a) grow and thrive;
- (b) meet all challenges and turn them to advantages;
- (c) use their resources wisely;
- (d) consistently satisfy their clients; and
- (e) Continuously and consistently earn profits.

The partners should work together as a team and make deliberate efforts to mitigate general business risks, especially the risks of losing clients and the risk of litigation. Any of these two types of risks can lead to the failure of the business, so it is in the interest of the partners to work assiduously to prevent such risks. They should ensure that their engagements are carried out professionally and in compliance with appropriate regulations and standards.

### **SELF-ASSESSMENT EXERCISE**

What are the issues that should be covered in a partnership deed?

### **3.3 Staff Management**

Managing people in organisations is a very important function and it is the key to the successful conduct of the organisation's business. Management has been defined in various ways but can be said to involve directing the use of an organisation's resources in a way that efficiently accomplishes the organisation's goals. More than ever before, managers now need skills in making the best use of the organisation's resources, especially its people. Successful managers are those who have moved beyond a focus on control and authority; replacing it with efforts to establish credibility, build commitment and lead a team. The traditional basic functions of manager (which consists of planning, organising, leading and controlling) are, however, still very relevant.

In recognition of the afore-mentioned, an audit firm should have in place a partner, called the staff partner, who is placed in charge of staff matters. He is to ensure that all staff receive due attention in matters affecting them. He is responsible for:

- (a) Acquiring the appropriate human resources through human resources planning, recruitment and selection. In this way, human resources made available to the firm are of the right calibre and in the right mix;
- (b) Annual performance evaluation to ensure that staff get adequately appraised and remunerated for good performance and those who do not measure up to standard are made aware of their inadequacies with a view to making them improve;
- (c) Welfare of staff generally, including arrangements for prompt payment of salaries, regular review of staff emoluments to ensure payment of competitive salaries to retain workers, adequate medical facilities, leave arrangement, etc.;
- (d) Staff training and development, focusing on employability rather than job security;
- (e) Preparation of staff work schedule on weekly basis; and
- (f) General administrative matters to keep work going and uninterrupted.

### **SELF-ASSESSMENT EXERCISE**

What are the responsibilities of the staff partner?

### **3.4 Quality Control**

An audit firm should be dedicated to the pursuit of the highest quality in all its operations. Quality control should not be in respect of each particular engagement only, but must be a culture in the entire firm.

Quality control policies and procedures should be documented and communicated to the firm's personnel. The International Audit and Assurance Standards Boards (IAASB), a standing committee of IFAC issued in February 2004, its first International Standard on Quality Control (ISQC) which provide guidance specifically on quality control for audit firms.

The thrust of the standard as set out in paragraph 1.3 of the ISQC is as follows:

“The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances” (ISQC 1.3).

Other important aspects of quality control in an audit firm are highlighted below:

- (a) An internal culture that considers quality as being important should be inspired by the leaders, that is, the partners of the firm; and in order to boost this, an individual or unit of the firm may be appointed to oversee quality in the firm;
- (b) In order to be reasonably assured that the firm's personnel can comply with professional standards and regulatory and legal requirements appropriate policies and procedures should be put in place to provide the firm with adequate staff that possess the capabilities, competence, and commitment to ethical principles required to perform its engagements;
- (c) The policies and procedures referred to in (b) above should cover recruitment, performance evaluation, promotion, career development, compensation, training and other personal needs and overall welfare of the firm's personnel;
- (d) An audit firm should have policies and procedures to ensure that the engagement partner (whose responsibility it is to assign the engagement team) is capable of performing his duties well, and the key staff of the client plus those charged with the client's governance know who the engagement partner is;
- (e) An audit firm should have a manual of standard engagement procedures given to all staff (either in hard or soft copy) to ensure that engagements are performed in accordance with those standards at all stages, that is, fieldwork and supervision stages;
- (f) An audit firm should have in place policies and procedures for the review and responsibility for issuing reports, that is, when and how the audit report should be issued.
- (g) An audit firm should have in place policies and procedures to determine when it will be necessary to use the services of a quality control reviewer that is, using second partner quality control review. This is compulsory for the audit of financial statements of all listed companies;
- (h) An audit firm should also have in place standards to determine what a suitable quality control review consists of, that is, documentation requirements, timing, nature, and extent of such a review, and the criteria for eligibility;
- (i) An audit firm should establish policies and procedures designed to provide it with reasonable assurance that consultation, if and when required, has been carried out and its nature, scope and conclusions have been documented;
- (j) As regard monitoring, an audit firm should have policies to ensure that its quality control procedures are adequate, relevant; operating effectively and duly complied with. A monitoring team should be put in place for this purpose; and

- (k) The results of the monitoring activity, which should be done either on a continuous or periodic basis, should be reported to the management of the firm on an annual basis and such reports should be treated appropriately by both the management collectively and each engagement partner in particular.

An example of monitoring activities and impact of report on such activities is that monitors may ignore deficiencies that are found as one-offs, but if the deficiencies are repetitive or systematic, corrective action must be taken. Again it in the course of monitoring, evidence is gathered that an inappropriate report might have been issued on a particular engagement, the audit firm may seek professional advice. This is a sort of pre-emptive action against a likely action for negligence.

### **SELF-ASSESSMENT EXERCISE**

Outline the various aspects of quality control.

## **4.0 CONCLUSION**

Continuous monitoring involves an on-going evaluation of the quality control system to ascertain if the system is up to date with regulatory and legal requirements and professional standards. This allows for a continuous review of the quality control system of the firm. On the other hand, periodic monitoring involves a periodic inspection of a sample of engagements selected in such a way that within a given period (say two or three years) at least one engagement per engagement partner would have been reviewed. The Institute has a special body called the Public Practices Monitoring Committee (PPMC) responsible for monitoring the quality of audit work of member firms.

Those medium sized firms having international cooperation with other firms and the “Big Four” firms usually have a standard manual of quality control system to be followed by all member firms. The other types of firms are encouraged to adopt the system of having a standard manual for the use of their staff. This is because there is really no substitute for ensuring that all engagements are carried out at the highest quality level.

In providing services to clients, an audit firm’s clients may be grouped into their various broad industrial sectors, for example, manufacturing, banking, insurance, etc. However, this will be a function of the size of the firm. Such groupings facilitate specialisation on the part of staff as well as the partners.

## **5.0 SUMMARY**

In this unit, we have discussed the management of a professional firm under four main sub-sections as follows:

- Office and office facilities;
- Partners' relationship;
- Staff management;
- Quality control;

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. What is an office?
2. Describe some office facilities.

## **7.0 REFERENCES/FURTHER READING**

Institute of Chartered Accountants of Nigeria. (2004). *Advance Audit and Assurance*. Lagos: ICAN.

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## UNIT 4 TRAINING AND AUDITORS' LIABILITY

### CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Training
  - 3.2 Standards for Assurance Engagement
  - 3.3 Expectation Gap
  - 3.4 Negotiation Skills
  - 3.5 Auditors' Liability
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### 1.0 INTRODUCTION

In this unit, we shall discuss training, standards for assurance engagement, expectation gap, negotiation skills and auditors' liability.

### 2.0 OBJECTIVES

After studying this unit, you should be able to:

- state the steps involved in the process for designing effective training systems
- describe the most common techniques that could be used for training personnel of an audit firm
- discuss the standards for assurance engagement
- highlight what an engagement letter should contain
- explain the term expectation gap
- state some of the key guidelines in the audit standard
- explain the general approaches to negotiation
- state the steps in the process of negotiation
- outline the provision of *CAMA* in respect of auditors' liability.

### **3.0 MAIN CONTENT**

#### **3.1 Training**

The professional reputation of an audit firm resolves heavily around the quality of the work performed, which in turn is a function of the type of personnel employed. The human resources, therefore, constitute the most valuable and vital resource of the firm. Audit firms must, therefore, have a policy of investing heavily in the training and re-training of all categories of their personnel. Training should always be accompanied with development of human resources because through training and development, the audit firm can enhance the skill of its personnel. Training and development activities may also enhance motivation and positive attitudes by making work more interesting and supporting such needs as achievement and self-esteem.

Training has been defined as “the organisation’s efforts to help employees learn job-related knowledge, skills and behaviour”; while development is defined as “the organisation’s efforts to help employees acquire knowledge, skills, and behaviours that improve their ability to meet changes in job requirements and customer needs” (Wright and Noe, 1996).

In order to have an effective training system, the audit firm will need to design the system that suits its requirements. The process for designing effective training systems could follow the steps listed below:

- (a) Assessment of training needs, based on the analysis of the entire organisation, the tasks, and each individual staff;
- (b) Assessment of employee’ readiness for learning;
- (c) Creation of a learning environment;
- (d) Ensuring transfer of training, that is, employees being able to apply what they have learnt to their jobs;
- (e) Selection of appropriate training methods; and
- (f) Evaluation of the training programme, including the opinion of the trainees about the programme and the impact of the programme on their behaviour. This is the step that provides feedback for modifying the organisation’s training system.

#### **Training Methods**

There are various methods of training from which an audit firm may select. There are formal, that is, outsourcing and informal, that is, in-house, training methods and the choice may be a function of the size of the audit firm and employees training needs.

The following are the most common techniques that could be used for training personnel of an audit firm:

**(a) Presentation Methods**

This involves the trainer telling or showing trainees the information that they are required to learn. These methods consist of lectures, use of audio-visual materials such as overhead projector slides, videotapes and multimedia facilities. They could take place in a classroom setting or via tele-conferencing. They are methods used for seminars, workshops and some in-house training programme;

**(b) Hands-on Training or Hands-on Learning**

This is used when trainees try new skills in the course of the training session. These methods include on-the-job training, business games, case studies, simulation, and interactive video; and

**(c) Group Building Techniques**

This method involves training programmes for building group identities and teaching inter-personal skills through discussions and shared experiences. It is particularly common for organisations using teamwork as they apply these techniques during retreats for their personnel.

### **Employment Development**

The key resource to any audit firm is the equality of its staff. In order to ensure high quality audit work, the firm should at all times have adequate quality and number of staff necessary for the efficient and effective execution of the audit requirements of its clients.

It follows then that the firm should have in place adequate procedures for:

- (a) Recruitment and retention of staff of the right quality; and
- (b) Training and re-training of its staff.

The staffing policy of the firm should be designed to ensure that only highly qualified personnel are recruited and that such staff are adequately trained to give them on the job experience. Hence the employment policy of the firm should be based on qualification, skill and cognate experience. It is necessary to adequately motivate the staff to ensure high morale and reduce staff turnover. Some firms source their trainees from among only university graduates with a minimum of a prescribed honours degree. Some firms have in-house training outfit where they organise formal and continuous training of their staff while

others outsource this to consultants. In all situations, the training and re-training of staff ensures that their skills and experience are constantly updated and are relevant to the needs of their clients.

In addition to the training and re-training of staff required to improve the skill and experience of audit staff, it is also essential for the firm to provide the necessary technical support to the staff to enhance their efficiency and effectiveness.

The type of technical support a firm may provide to its staff will include; audit manuals, standard audit programme, standardised working papers, internal control questionnaires, and checklists, provision of professional journals, internal newsletters, personal computers, and computer audit software.

Technical support provided to staff tends to standardise performance and help in the review processes. The technical support, especially audit manual, which the firm provides to its staff, is a very good reference material to audit staff which guides them at all stages of the engagement. Employee development requires that the audit firms use some combination of formal education, assessment, job experiences, and interpersonal relationships. These methods are geared mainly at ensuring that the firm's workforce is prepared for the growth and survival of the organisation:

- (a) Formal education is aimed at attaining more qualifications, for example, audit trainees who are encouraged to take the professional examination of the Institute, qualified staff who are encouraged to obtain post-graduate qualifications through part-time programmes (at the Universities) in the vicinity of the firm;
- (b) Assessment is done by collecting information about employees' behaviour, communication style, or skills and then providing the employees with a feedback. This is used to identify the employees' strengths, weaknesses, and their potential for occupying management positions;
- (c) Job experiences are designed by the organisation to expose employees to various aspects of the entire operations of the organisation. This could be done by both vertical and lateral moves; vertical moves through promotions and lateral moves through job rotation or transfer; and
- (d) Interpersonal relationships are promoted by the organisation when deliberate attempts are made to encourage employees or managers to be *mentored* by more experienced members of the organisation. This is aimed at enhancing the development of the employee or manager with less experience.

**Note**

The “Big Four” firms or some of the medium-sized firms can arrange for some of their staff to go on overseas training or attachment to offices of their overseas sister firms. In some cases, they may send some of their senior staff for either local or overseas “train-the-trainers” courses, which in turn will provide the opportunity for those who have been so trained to transfer such training to other employees.

**SELF-ASSESSMENT EXERCISE**

What are the steps to be followed for the process of designing effective training systems?

**3.2 Standards for Assurance Engagement**

The International Standard on Auditing (ISA No. 100 on Assurance Engagements) defines assurance engagement as “one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria”. When this definition is put in the content of a statutory audit as a type of assurance service, then it can be written thus:

“A statutory audit is an assurance engagement in which an auditor expresses opinion on a set of financial statements designed to enhance the degree of confidence of the shareholders, other than the management, about the outcome of the evaluation or measurement of the financial statements against accounting standards/laws.”

In other words, an audit is an assurance engagement exercise aimed at giving an independent opinion on the truth and fairness of financial statements. The traditional role of auditing has been centred around giving assurance on the assertions made by the management of an enterprise in the financial statements prepared in respect of that enterprise. This is an assurance service offered to the owners of the enterprise and in the case of a company, the assurance service is offered to the shareholders.

**Underlying Concepts of Assurance Engagement**

The need for assurance service has arisen because of the fact that owners and managers of businesses are often different people such that owners (shareholders) would require more confidence in the report of managers (directors). This need has continued to be pertinent as result of the

increase in the volume of information made available and required as a result of the following development:

- (a) Growth in international communication methods especially the proliferation of reporting on the internet and the use of the World Wide Web; and
- (b) Additional areas in respect of which information is required, may relate to corporate social responsibility, environment reporting, corporate governance, etc.

### **Elements**

The various elements which are peculiar to assurance engagement are:

- (a) Existence of a three-party relationship which involves:
  - i. The practitioner
  - ii. The responsible party; and
  - iii. The intended users
- (b) Identification of the subject matter
- (c) Existence of suitable criteria
- (d) Availability of sufficient appropriate evidence; and
- (e) Written assurance report in appropriate form to include appropriate conclusion.

### **Types of Assurance Engagement**

There are, basically, two types of assurance engagement and they are:

- (a) An assertion-based engagement, where the accountant declares that a given assertion, that is, claim or declaration is in his opinion true. An example of this type is the statutory audit; and
- (b) A direct reporting engagement, where the accountant reports on issues that have come to his attention during his evaluation. An example of this is a management performance report.

### **Peculiarities of Assurance Engagement**

There are certain peculiarities of assurance engagements:

- (a) Those that vary according to the elements of the engagement, for instance, depending on the engagement itself, the criteria and the subject matter the level of assurance that the practitioner can give is either reasonable or limited. It is not possible to give an absolute level of assurance because of the limitations inherent in

the process of carrying out the assignment. There are two possible levels of assurance and they are:

- i. Reasonable, that is, high level of assurance, where the practitioner would conclude that the subject matter materially conforms to the criteria, for example, a statutory audit; and
  - ii. Limited level of assurance, where the practitioner has no reason to believe that the subject matter does not conform to the criteria, that is, he believes that it is possible that the subject matter conforms to the criteria.
- (b) Those that depend on the subject matter. In this case, the subject matter may fall into any of the following three categories:
- i. Data (financial statements or forecasts);
  - ii. Systems and procedures (internal control systems or computer systems); and
  - iii. Behaviour (corporate social responsibility, environmental performance or corporate governance)

### **Characteristics of Assurance Engagement**

A matter that can be subjected to an assurance service should have the characteristics of being:

- (a) identifiable;
- (b) capable of consistent evaluation and measurement; and
- (c) capable of procedures and evidence gathering.

There are many examples of assurance engagements. The statutory audit is the most common example. Other examples include the following reports on:

- (a) Management performance
- (b) Risk assessments
- (c) Corporate governance
- (d) Performance related data
- (e) Systems and controls
- (f) Corporate social responsibility performance
- (g) Prospective financial information
- (h) Environmental performance
- (i) Report for lenders and other investors
- (j) Reports relating to e-commerce; and
- (k) Non-statutory audits and reviews.

In view of the recent developments in the accounting profession, resulting in the growth of assurance services, it is necessary to draw attention to the implications of this trend for the profession.

Each audit firm should be conscious of the following implications:

- (a) Possibility of declining audit requirement resulting in decrease in audit fee but compensated by an increase in fee income from other assurance services;
- (b) Need for accountants to acquire a broad skill base in order to meet the requirements of non-audit assurance services;
- (c) Increase in potential liability of accountants resulting from a diversity of engagements; and
- (d) From the point of view of the public:
  - i. Increase in expectation gap; and
  - ii. Possibility of mistaking all other assurance services as audit in re-packaged form.

### **Quality Control Practices and Procedures**

Quality control at the level of an audit firm has been covered in the previous unit. Quality control in this unit is in respect of an individual assurance engagement, in this case, the individual audit assignment. There is an International Standard on Auditing – ISA 220 on Quality Control for Audit work. The auditing standards or guidelines issued by ICAN are normally in conformity with the International standards and guidelines issued by IAASB. However, where there is a conflict between the two, the Institute's Standards and Guidelines will prevail. The audit engagement partner is responsible for each audit engagement assigned to him right from the beginning to the conclusion. He has an engagement team (the staff assigned to the assignment) who should work together to implement quality control measures that are applicable to each particular audit engagement.

The Quality Control Standard covers the following different sections:

#### **(a) Leadership Responsibilities**

The engagement partner should take responsibility for the overall quality on each audit engagement assigned to him.

#### **(b) Ethical Requirements**

The engagement partner should consider whether members of the engagement team have complied with ethical requirements, as stated for

example in the Professional Conduct of Members of ICAN (Fundamental Principles and Statements).

**(c) Acceptance/Continuance of Client Relationships and Specific Audit Engagements**

The engagement partner must ensure that the requirements of the standard on quality control in respect of accepting and continuing with the audit engagement) are met. If he has received any information that would have made him to decline the engagement in the first place, he should immediately communicate that information to the firm the purpose of taking quick action.

**(d) Assignment of Engagement Teams**

The audit engagement partner is responsible for ensuring that the engagement team is appropriately experienced and qualified as a unit fit for the particular assignment.

**(e) Engagement Performance**

This consists of various factors for which the engagement partner is responsible. These factors include direction, supervision, review, consultation, differences in opinion, and quality control:

- i. Under direction, the engagement partner should inform members of the engagement team of their responsibilities, nature of the entity's business, risk-related issues, problems that may arise and the detailed approach to the performance of the assignment;
- ii. Under supervision, the audit engagement partner is the overall supervisor for the whole assignment but it is usual that within the team, the senior members supervise the junior ones. For example, the audit manager supervises the audit senior, etc.;
- iii. Under review, the work is subjected to constant evaluation to ensure that the objectives of the engagement procedures are met and the evidence obtained is both appropriate and sufficient. The audit engagement partner must be sure of a thorough review before issuing the audit report;
- iv. Under consultation, the partner should ensure that difficult and/or contentious matters are subjected to appropriate consultation and well documented;
- v. Differences of opinion could arise between the audit staff and their manager or between the entire audit team and their audit engagement partner or even between the partner and the quality control reviewer. In any of these cases, the differences should be resolved in accordance with the firm's policy for such matters.

- vi. Quality control review requires the audit engagement partner to appoint a reviewer with whom he discusses and finalises all significant matters before issuing the audit report.

**(f) Monitoring**

The audit engagement partner should refer to the results of monitoring of the firm's quality control systems and consider whether such results have any impact on the particular audit that he is conducting.

**Quality Control Review**

In view of the importance of quality control review, which is the concluding part of the engagement performance section, it is considered essential to mention here that a good quality control review should include:

- (a) an evaluation of the significant judgments made by the engagement team, for example, materiality and significant risks; and
- (b) an evaluation of the conclusions reached in formulating the auditor's report, for example, conclusions on difficult/contentious issues or on matters having differences of opinion.

**Advertising and Publicity**

Advertising and publicity for Chartered Accountants in public practice (auditors) are covered under Statement No. 8 of the Professional Conduct for Members. The institute appreciates that auditors are in business and, therefore, need to advertise their services, and seek publicity for their products and achievements. The Institute, therefore, gives the following guidance on advertising and publicity:

- (a) A member is allowed to seek publicity for and advertise his/her services, achievements and products in any way consistent with the dignity of the profession;
- (b) In doing so, he/she should not project an image inconsistent with that of a professional person bound to high ethical and technical standards;
- (c) Advertisements should be clearly distinguishable as advertisements;
- (d) Advertisements must comply with the law and should be legal, decent, clear, honest and truthful;
- (e) If reference is made in promotional material to fees, members should not make comparison in such material between their fees

- and the fees of other accounting practices, whether members or not;
- (f) Promotional material should not make disparaging references to or disparaging comparison with the services of others, for example, claims of size or quality are subjective and may be difficult to substantiate and therefore should be avoided;
  - (g) Unsolicited promotional or technical material should not be sent to a non-client by facsimile transmission or other electronic means; and
  - (h) In relation to audit or other financial reporting work, a member should not make an unsolicited personal visit or telephone call to a person who is not a client with a view to obtaining professional work from the non-client.

### **Fees**

Section 361 of CAMA provides that the remuneration of auditors may be fixed by the directors, if the auditors are appointed by the directors. However, in other cases, the auditors' remuneration shall be fixed by the company at the annual general meeting or in such manner as the company in general meeting may determine. Remuneration in this context consists of the auditors' fees and expenses.

Statement No. 7 in ICAN's Professional Conduct for Members makes extensive provisions for fees to be charged by Chartered Accountants, and these provisions are highlighted below:

- (a) It is noted that a chartered accountant is entitled to charge for his/her services:
  - i. Such specific fee as he/she has agreed with the client; or
  - ii. A fee calculated in accordance with any agreement with the client; or
  - iii. In the absence of an agreement, a fee calculated by reference to the custom of the profession.
  
- (b) In the case of where there is no agreement on the basis of the fee, a member of the Institute should charge a fee which is fair and reasonable, having regard to:
  - i. The seniority and professional expertise of the persons necessarily engaged on the work;
  - ii. The time expended by each of those persons;
  - iii. The degree of risk and responsibility which the work entails; and

- iv. The priority and importance of the work to the client; and any expenses properly incurred.
- (c) As regards fee quotations and estimates, a member should inform a client in writing, prior to the commencement of the engagement, of the basis upon which any fee he proposes to charge that client for his services will be calculated and, on request and where practicable, the level of fees likely to be charged for any assignment. All these must be preceded with discussions with the client during which explanations of the basis on which fees are charged must have been given. The information on fees is usually provided in the Engagement letter.
- (d) Quoting a fee that is lower than that of another member is not considered improper by ICAN's guidelines. However, such a member should take care to ensure that the client has a full and complete understanding of:
  - i. the services to be covered by the fee; and
  - ii. the basis on which the fee is to be determined both for the current and future years.
- (e) Audit firms obtaining work having quoted levels fees which are significantly lower than those charged by existing auditors or quoted by other tendering firms should be aware that their objectivity may appear threatened. Such firms should be prepared to demonstrate, in the event of a complaint being made to the Institute, that:
  - i. the work done was in accordance with Auditing Standards and Guidelines; and
  - ii. the client was not misled as to the basis on which fees for the current year and subsequent year were to be determined.
- (f) In cases where fees rendered exceed, without prior agreement, a quotation or estimate or indication of fees given by a member by more than a reasonable amount, the member should be prepared to provide the client with a full and detailed explanation of the excess and to take steps to resolve speedily any dispute which arises.
- (g) A member whose fees have not been paid may be entitled to retain certain books and papers of a client upon which he/she has been working, by exercising a lien and my refuse to pass information to the client or his successor accountant until those

fees are paid. Such a member should however be prepared to take reasonable steps to resolve any dispute relating to the amount of that fee.

- (h) Fees should not charge on a percentage, contingent, or similar basis in respect of audit work, reporting assignments and similar non-audit roles incorporating professional opinions including expert witness assignments. This is because such methods may be perceived as a threat to objectivity and for other works as requiring such methods to be used; a member should only adopt such methods after careful consideration.
- (i) Cases where percentage, contingent, or similar basis could be used include:
  - i. Bankruptcies, liquidations, receiverships, administrations, voluntary arrangements and similar work where percentage of realisation/distribution is required either by statutory provisions or by tradition; and
  - ii. Advising on a management buy-out, raising of venture capital, acquisition search or sales mandates, where a contingency basis is applicable.

In either case, the capacity in which a member has worked and the basis of remuneration should be made clear and well documented by the member in contemplation that a third party may have to rely on it.

- (j) Referencing to fees in promotional material has been covered under advertising and publicity.

### **Tendering**

In view of the guidelines in Statement No. 8 of ICAN's Professional Conduct for Members, covering "Obtaining Professional Work", which has been referred to under Advertising and Publicity, tendering should commence only when a firm has been approached by a prospective client. Before proceeding to tender, the auditors (either the sole practitioner or the partners) have decided that their firm is capable of carrying out the assignment at a reasonable fee.

Therefore, whenever a firm is approached by a prospective client, the auditor will have to consider many factors including:

- (a) Whether he/she wants to do the work, considering all the necessary ethical factors
- (b) Whether he/she is not disqualified by any statutory provisions from carrying out the assignment
- (c) Whether the firm has available the appropriate calibre of staff for a job, and if not what will be required to get the appropriate staff
- (d) Whether the proposed timetable for the work fits with the firm's current work plan
- (e) Whether non-accounting specialist skills are necessary, and if so, which ones are required
- (f) Whether staff shall need further training for the work, and if so how much will such training cost; and
- (g) What fees to quote for the work?

A tender (which is the audit proposal) does not have a particular format. The format is usually a function of what the prospective client wants the audit firm to do. However, there are usually some vital matters which should be included in the tender while the tender could either be in the form of a document sent to the prospective client or presented by members of the audit firm at an agreed time and date. Some of the important matters are:

- (a) An assessment of the needs of the prospective client, for example, audit, taxation, accounting
- (b) The proposed approach to the engagement
- (c) The assumptions made to support the proposed approach
- (d) An outline of how the firm intends to meet those needs, including the key staff to be involved
- (e) The fee and the basis on which it has been calculated or estimated; and
- (f) A brief outline of the firm.

### **Note**

Tendering should be handled as professionally as possible; no assumptions of familiarity with the prospective client should be made. It should be borne in mind that the prospective client must have invited other firms to tender as well; and this simply implies that the tender being submitted should be comparable with the other firms might submit. It should also be competitive enough.

### **Engagement Letter**

The Auditing Standards Committee of ICAN issued an Auditing Guideline on Engagement Letter in November 1990. The Guideline gives guidance on the procedures to be followed before the

commencement of an audit. The principles contained in the Guideline, which are highlighted below should also be followed in the case of non-audit engagements. If purely accounting services are provided to a non-corporate client, the engagement letter should specify clearly that these services will be performed without any audit work being carried out.

The principles are as listed below:

- (a) The purpose of an engagement letter is to define clearly the extent of the auditor's responsibilities and so minimise the areas of misunderstanding between the client and the auditor.  
It also provides written confirmation of the auditor's acceptance of his appointment, the scope of the audit and form of his report;
- (b) It is in the interest of both the auditor and the client that the contents of the engagement letter be agreed. Therefore, the contents of the letter should be discussed and agreed with management before it is sent and preferably prior to the commencement of the audit
- (c) The engagement letter should be addressed to the Board of Directors of a client's company
- (d) Where the company has subsidiary companies, a separate engagement letter should be sent by the auditor to the Board of Directors of each company in the group which he/she is auditing;
- (e) Where more than one firm of auditors are involved in the audits of the group, the respective responsibilities of the holding company auditor and the subsidiary companies' auditors should be clearly defined in the engagement letter
- (f) Where there are joint auditors, the audit engagement should be explained in similar terms by each auditor. The auditors should agree whether a joint letter or separate letters should be sent to the client. Where other services are provided by one of the firms, separate letters would normally need to be sent on the joint audit engagement
- (g) The auditor should request confirmation from the Board of Directors that the terms of the engagement letter have been accepted; and
- (h) Once it has been agreed by the client, an engagement letter will, if it so provides, remain effective from one audit appointment to another, until it is replaced. However, a revised engagement letter may be necessary to ensure that it continues to reflect the client's circumstances and if there has been a significant change in the client's management, a prior discussion and agreement with the client may also be necessary.

An engagement letter should contain the following:

- (a) Responsibilities and scope of the audit
- (b) Reference to special arrangements, for example, internal auditors, other auditors, overseas subsidiaries
- (c) Representation by Management, if required before the completion of the audit
- (d) Irregularities and fraud- the responsibilities of the Management vis-a-vis the auditors on this should be specified clearly
- (e) Accounting and taxation services, if any
- (f) Fees and the basis of calculation or estimation; and
- (g) Agreement of terms to be in written form.

### **The Practical Aspects of an Engagement Letter**

Most accountants do not see any need to send an engagement letter. This is borne out of the fact that it occasions delays and in any event, most clients do not understand nor do they expect the letter and even when one is written they rarely send a reply. This is also the result of ignorance on the part of most clients, who would view a letter of engagement with suspicion as most of them (the clients), would consider the appointment of an auditor as all inclusive; keeping the accounting records, preparing the financial statements, dealing with the tax matters and of course discovering fraud and error; in fact stamping them out. The client in most cases, at best will be disappointed to read in the first letter from the auditor that he will not discover fraud and errors. Nevertheless, it is the duty of the auditor to send the letter at the most appropriate time when the client is better disposed to understand its relevance. But regardless of the disposition of the client, it is still in the interest of the auditor to send a letter of engagement at any new engagement in line with the recommendations of IAG 2.

A letter of engagement serves to define clearly the extent of the responsibilities of the auditor by documenting and confirming the:

- Auditor's acceptance of his appointment
- Objective and scope of the audit
- Extent of the auditor's responsibilities; and
- Form of his report.

The client should be encouraged to send a reply to the letter of engagement. The best procedure will be to discuss the terms of the engagement before sending the letter.

## **Consultation**

This is one of the several factors involved in engagement performance, as indicated under quality control practice and procedures discussed earlier on. The International Auditing Standard on Quality Control states that “the firm should establish policies and procedures designed to provide it with reasonable assurance that:

- (a) Appropriate consultation takes place on difficult or contentious matters
- (b) Sufficient resources are available to enable appropriate consultation to take place
- (c) The nature and scope of such consultations are documented; and
- (d) Conclusions resulting from consultations are documented and implemented” (ISQC 1.51).

The above requirements may involve external consultation, for example, with other experts, or other firms or with the Institute. Whenever there is any difference in opinion within the engagement team or between the engagement partner and the quality reviewer, such differences must be resolved before the report is issued by the engagement partner.

The audit firm should have in place policies and procedures to determine when a quality control reviewer will be necessary for an engagement. For instance, a quality control reviewer will be necessary for all audits of financial statements in respect of listed companies.

## **Performance and Reporting Standards**

When all the quality control procedures in respect of an audit assignment have been concluded, the audit engagement partner will be in position to form the audit opinion as to the truth and fairness of the financial statements against the existing accounting standards/law. This is the main crux of the report.

At this level, you would have been familiar with the different types of audit opinion that can be given and the circumstances leading to each type. This is, however, stated below:

- (a) Unqualified audit opinion- when the accounts show a true and fair view.
- (b) Modified audit report, for example, “accounts show a true and fair view except for .....” – When material item(s) in the accounts do not show a true and fair view.
- (c) Adverse audit opinion – when a true and fair view is not shown because of extensive disagreement on the accounts.

- (d) Modified audit report for example, “accounts show a true and fair view except for ....., plus any implied opinion” – when the auditor cannot confirm a true and fair view in respect of material items(s), due to limitations in scope.
- (e) Disclaimer of opinion plus any implied opinions- when the auditors cannot confirm whether a true and fair view is given at all, due to a limitation in scope.

The audit report should be addressed to the shareholders to whom the auditors have their primary and statutory responsibilities. It should however, be noted that audited accounts are usually used by many groups of accounting information users, regardless of whether they are shareholders or not.

You should be familiar with standard unqualified audit report by now. ISA 700 on “The Auditor’s Report on Financial Statements” outlines the standard audit report.

This report has certain elements designed to remove common misconceptions by the users of audited accounts. These elements include:

- (a) The report is clearly addressed to the members of the company (that is, the shareholders)
- (b) The report contains an introductory paragraph stating what the report refers to
- (c) The report contains paragraphs indicating the respective responsibilities of directors and auditors
- (d) The report contains paragraphs explaining the basis of the auditors’ opinion (the basis on which they have come to their conclusions)
- (e) The report contains a paragraph expressing the auditors’ opinion (the opinion paragraph)
- (f) In the case of the audit of financial statements of banks, there is usually a paragraph preceding the opinion paragraph, stating contraventions of BOFIA and/or CBN circulars, if any. This paragraph will also refer to where in the financial statements the particulars of such contraventions can be found
- (g) The report must be signed and dated by the auditors; and
- (h) The auditor must not sign the report until the Board has approved the financial statements.

### **SELF-ASSESSMENT EXERCISE**

What are the various elements peculiar to assurance engagement?

### **3.3 Expectation Gap**

The role of an auditor is usually misconstrued by the public including the investment community. While some people think that the auditor is responsible for preparing the accounts and/or dealing with tax and/or keeping the books, only few people really understand how restricted the role of the auditor is. People generally expect more from an auditor than what he/she is actually statutorily required to do and that is really the cause of the expectation gap.

ISA 200 makes an essential point on this issue by stating that:

“While the auditor is responsible for forming and expressing an opinion on these financial statements, the responsibility for preparing and presenting the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance. The audit of the financial statements does not relieve responsibilities.”

It is also important to note the fact that contrary to public expectation, the auditor is merely a watch-dog rather than a bloodhound (Re Kingston Cotton Mill Co., 1896). In other words, the auditor does not have primary responsibility as regards prevention and detection of fraud; though the detection of fraud may be incidental to his duties. It is management, as well as those charged with governance that is primarily responsible for prevention and detection of fraud.

#### **Fraud**

Fraud consists of both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by one or more individuals among management, employees or third parties.

#### **Errors**

Errors are unintentional mistakes in financial statements resulting in material misstatement. The mistake may be committed at any stage in the accounting cycle and may be mathematical, clerical, or simply in the application of accounting policies.

#### **Types of fraud**

There are two types of fraud that can cause material misstatement in financial statements. These are itemised below:

- (a) Fraudulent financial reporting such as:
  - i. Misrepresentation or omission of events or transactions in the financial statements
  - ii. Intentional misapplication of accounting principles; and
  - iii. Manipulation, falsification or alteration of accounting record supporting documents.
- (b) Misappropriation of assets such as:
  - i. Stealing of physical assets or intellectual property (cash, inventory or selling data)
  - ii. Causing an entity to pay for goods not received
  - iii. Embezzling receipts of cash and cheques (diverting same to private bank accounts); and
  - iv. Using entity's assets for personal purpose.

It should be noted that fraudulent financial reporting usually involves management when embarking on window dressing or creative accounting in their bid to have aggressive earnings. ISA 240 deals with "Fraud and Error". It gives guidelines on how the auditor is to handle the possibility of the occurrence of fraud. Some of the key guidelines in the audit standard include the following:

- (a) In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud (ISA 240.3)
- (b) The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance (ISA 240.4)
- (c) Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud (ISA 240.27); and
- (d) When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make enquiries of management regarding:
  - i. Management's assessment of the risk that the financial statements may be materially misstated due to fraud
  - ii. Management's process for identifying and responding to the risks of fraud in the entity including any specific risks of fraud that management has identified or account

- balances, classes of transactions or disclosures for which a risk of fraud is likely to exist
- iii. Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
  - iv. Management's communication, if any, to employees regarding its views on business practices and ethical behaviour (ISA 240.34).
- (e) The auditor should make enquiries of management, internal audit and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity (ISA 240.38)
  - (f) The auditor should obtain understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks (ISA 240.43)
  - (g) The auditor should make enquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity (ISA 240.46)
  - (h) When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present (ISA 240.48)
  - (i) When identifying and assessing the risks of material misstatements at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented (ISA 240.57)
  - (j) The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level (ISA 240.61)
  - (k) In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level, the auditor should:

- i. Consider the assignment and supervision of personnel
  - ii. Consider the accounting policies used by the entity; and
  - iii. Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures (ISA 240.66).
  
- (l) To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:
  - i. Test the appropriateness of journal entries in the general ledger and other adjustments made in the preparation of the financial statements
  - ii. Review accounting estimates for biases that could result in material misstatement due to fraud; and
  - iii. Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity's understanding of the entity and its environment (ISA 240.76).
  
- (m) If the auditor has identified a fraud or has obtained information that indicates a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management (ISA 240.93)
  
- (n) If the auditor has identified fraud involving:
  - i. Management
  - ii. Employees who have significant roles in internal control; or
  - iii. Others where the fraud results in a material misstatement in the financial statements.

The auditor should communicate these matters to those charged with governance as soon as practicable (ISA 240.93).

In all the above guidelines, the engagement partner should ensure that all the procedures are adhered to. As he is the one responsible for the entire engagement, he should make the engagement team carry out all the procedures.

In addition to the above, it is necessary to note that the need for documentation cannot be overemphasised. The following should be properly documented:

- (a) The important decisions of the audit engagement team emanating from their discussion with regard to fraud
- (b) The identified and assessed risks of material misstatement due to fraud
- (c) The overall responses to assessed risks
- (d) Results of specific audit tests; and
- (e) Any communications with management.

An important communication with management is obtaining a written representation that management accepts its responsibility for the prevention and detection of fraud and that it has made all relevant disclosures to the auditors. The auditor should consider seriously the need to withdraw from the engagement if he uncovers exceptional circumstances with regard to fraud.

### **SELF-ASSESSMENT EXERCISE**

What is the difference between error and fraud?

### **3.4 Negotiation Skills**

Negotiation is simply a discussion entered into with a view to reaching an agreement. It is the process to agree upon the exchange rate for them. It may just be a case of services being exchanged for a consideration. The process of negotiation provides the interactions of almost everyone in groups and organisations. Circumstances requiring negotiations are sometimes obvious, while in some cases they are subtle.

As regards auditors, negotiation becomes necessary for the purpose of agreeing fees with prospective clients, or agreeing increases in fees with their existing clients, or in cases when they need to act on behalf of their clients. In whatever situation it is, the auditor has to be an effective negotiator.

There are two general approaches to negotiation, that is, distributive bargaining and integrative bargaining:

- (a) Distributive bargaining operates under zero-sum conditions and has the following characteristics:
  - i. The amount of resources to be divided is fixed.
  - ii. The primary motivation is “I win, you lose.”
  - iii. The primary interest of the two parties are opposed to each other.
  - iv. The focus of relationships is short-term.

- (b) Integration bargaining operates under the assumption that there exists one or more settlements that can create a win-win solution. It involves the following characteristics:
- i. There is a variable amount of resources to be divided.
  - ii. The primary motivation is “I win, you win.”
  - iii. The primary interest are convergent and congruent with each other.
  - iv. The focus of the relationship is long-term.

In terms of inter-organisational behaviour, all things being equal, integrative bargaining is preferable to distributive bargaining. This is because the former builds long-term relationships and facilitates working together in the future. It bonds negotiators and allows each party to leave the negotiation meeting with a feeling of victory.

On the other hand, distributive bargaining leaves one party a loser. It tends to develop animosities and deepen divisions when people have to work together on a continuing basis (as is the case of auditors and their clients) however, there is a tendency to see more of distributive bargaining within organisations because of the fact that the conditions required for integrative bargaining seldom exist within organisations.

### **The Negotiation Process**

The process of negotiation can be viewed as being made up of five steps. These are considered below:

- (a) Preparation and planning.
- i. Do your homework thoroughly.
  - ii. Find out the nature of the conflict.
  - iii. Investigate to know the history leading to the negotiation.
  - iv. Find out who is involved and what their perceptions of the conflict are.
  - v. Identify what you want to achieve from the negotiation - that is, your goals.
  - vi. Prepare an assessment of what you think the other party's goals are, i.e.-
    - What are they likely to demand?
    - What are they likely to settle on?
    - What are their strengths and weaknesses?
    - Then develop a strategy.

- (b) Definition of ground rules, i.e.-
  - i. Who will do the negotiation?
  - ii. Where will it take place?
  - iii. What time constraints, if any, will apply?
  - iv. To what issues will the negotiation be limited?
  - v. In the case of an impasse, will there be a specific procedure to follow?
  - vi. Exchanging initial proposals or demands.
  
- (c) Clarification and justification:
  - i. Explanation/clarification and justification of initial position should be made.
  - ii. Documentation may be exchange to support each party's position.
  
- (d) Bargaining and problem solving:
  - i. Begin with a positive overture, for example, a small concession
  - ii. Address problems, not personalities; that is, discuss issues not the other parties' personalities; that is, discuss issues, not the other parties' personal characteristics
  - iii. Emphasise win-win solution; and
  - iv. Create an open and trusting climate.
  
- (e) Closure and implementation:
  - i. Ensure that the agreement that has been worked out is well formalised
  - ii. Develop any procedures that are necessary for implementation and monitoring; and
  - iii. Spell out the specifics in a format contract.

### **Issues to Note in Negotiation**

There are four contemporary issues in negotiation:

- (a) The role of personality traits is significant. Personality traits have no significant direct effect on either the bargaining process or negotiation outcomes. You may not be able to predict the other party's negotiating tactics by virtue of your knowledge of his/her personality.
- (b) Gender differences are not significant in negotiating. Women are "neither worse nor better negotiators, neither more cooperative

- nor open to the other, and neither more nor less persuasive nor threatening than are men” (Robbins, p.454).
- (c) The effect of cultural difference is significant in negotiating styles. Negotiating styles clearly vary across national cultures, even across tribal culture in some countries. Different cultures have their own norms on the appropriate way to negotiate.
  - (d) The use of third parties could be significant in helping to resolve differences. In some cases, direct negotiation may result in a stalemate, whereby the parties may have to turn to a third party to help them find a solution. In such a situation, the third party may play any of four roles, namely:
    - i. A mediator – This is a neutral third party who facilitates a negotiated solution by using reasoning, persuasion and suggestions for alternatives.
    - ii. An arbitrator – This is a third party to a negotiation who has the authority to dictate an agreement.
    - iii. A conciliator – This is a trusted third party who provides an informal communication link between the negotiator and the opponent.
    - iv. A consultant – This is an impartial third party, skilled in conflict management, who attempts to facilitate creative problem solving through communication and analysis.

### **An Effective Negotiator**

Having considered the meaning of negotiation and its other attributes, one could then deduce that an effective negotiator should be a skilled negotiator. He/she should be:

- (a) conversant with the meaning of negotiation
- (b) knowledgeable about negotiation process
- (c) familiar with the contemporary issues in negotiation
- (d) committed to the goals of his/her organisation.

An effective negotiator should be a good listener, who focuses his/her arguments more directly and asks more questions, is less defensive and has learnt to avoid words and phrases that can irritate the other party. The goal should be to reach an integrative settlement, whereby the two parties to the negotiation can be in position to declare a victory.

### **SELF-ASSESSMENT EXERCISE**

What are the characteristics of distributive and integration bargaining?

### 3.5 Auditor's Liability

Section 368 of CAMA provides the liability of auditors for negligence as follows:

- (a) "A company's auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance
- (b) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by subsection (1) of this section, the auditors shall be liable for negligence and the directors may institute an action for negligence against him in the court; and
- (c) If the directors fail to institute an action against the auditor under subsection (2) of this section, any member may do so after the expiration of 30 days' notice to the company of his intention to institute such action".

The auditor does not owe his duty of care only to the company or the members of the company; he also owes it to third parties who may rely on his special skill and judgment. In view of the fact that third parties do not have any contract with the audit firm, they will need to prove to the court that a duty of care which is enforceable at law existed as at the time the negligence was committed by the auditor.

Negligence is a legal concept that seeks to provide compensation to a person who has suffered loss due to another person's wrongful neglect. In case of auditor, a negligent misstatement through lack of care, include:

- (a) The company
- (b) The shareholders of the company as a body
- (c) The bank as a key financier of the company
- (d) Other lenders; and
- (e) Other interested third parties, (individual shareholders in the company or an potential investor).

In order to succeed in an action for negligence, an injured party must prove the following:

- (a) A duty of care which is enforceable at law existed
- (b) This duty of care was breached by the auditor; and
- (c) The breach caused the injured party loss.

**Note**

A duty of care exists between a company and its auditor, so this does not need to be proved by a company bringing an action for negligence against an auditor:

- (a) Where loss has arisen, but no negligence can be attributed to the auditor, he cannot be held liable for damages. On the other hand, where negligence has been proved against the auditor, liability for damages will arise only if an actual loss has arisen as a result of the negligence
- (b) Any provision in the Articles of association of a company or in any contract with a company for exempting an auditor from liability for the consequence of his negligence or breach of duty is void
- (c) In spite of the provisions of section 368(2) of CAMA, if the court thinks that the auditor, though liable, had acted honestly and reasonably and ought fairly to be excused, the court may relieve him from liability on such terms as it thinks fit
- (d) Banks and other major lenders may include a clause in loan agreements referring to audited accounts and requesting that they have access to such accounts on a regular basis or whenever the loan facility is being reviewed. This is with a view to creating a “relationship” with the auditors in order to be able to establish that a duty of care does exist after all; and
- (e) In a negligence action, audit firms always prefer to settle out of court to avoid bad publicity and save time and costs.

**Auditors’ Professional Liability under Statute**

Auditors may be found guilty of certain offences under certain circumstances as:

- (a) Under insolvency legislation, auditors may be found as fiduciary officers of the company and be charged with criminal offences or found liable for civil offences in connection with winding up of the company
- (b) Under money laundering Act, if they fail to report a person (whom they know or suspect of laundering money) to the appropriate authority; and
- (c) Insider dealing, which is a criminal offence, as they are by virtue of their position always privy to insider information.

## **Litigation Avoidance**

Apart from preferring to settle negligence actions out of court, audit firms also try to avoid litigation by any of the following actions:

- (a) At the stage of accepting a new engagement – the procedure is followed carefully, especially when new clients are to be screened to decide whether to accept the nomination or invitation to tender or not. This can be further enhanced by a proper use of the engagement letter
- (b) At the stage of performing the audit work – the audit firm should ensure that all audits are carried out in accordance with professional auditing standards, guidelines and best practice;
- (c) Quality control should be applied both at the level and also at the level of each individual audit; and
- (d) Issuing of appropriate disclaimers whenever it is considered necessary.

## **Professional Indemnity Insurance**

This is insurance against civil claims made by clients and third parties arising from work undertaken by the firm. It is in the interest of Chartered accountants to take up insurance policy, so as to be in position to compensate clients for any error made by the accountant and also to prevent the burden of such compensation leading to their own bankruptcy.

## **SELF-ASSESSMENT EXERCISE**

What is the provision- according to Section 368 of CAMA, for the liability of auditors for negligence?

## **4.0 CONCLUSION**

The Institute requires that its members who are in public practice, that is, those holding practising licence, take up an insurance policy with a reputable insurer.

## **5.0 SUMMARY**

In this unit, we have discussed the management of a professional firm under five main sub-sections as follows:

- (a) Training
- (b) Standard for assurance engagement
- (c) Expectation gap
- (d) Negotiation skills; and
- (a) Auditor's liability.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Training should always be accompanied with \_\_\_\_\_ of human resources in order for an audit firm to be able to enhance the skills of its personnel.
2. The training methods from which an audit firm may select could either be \_\_\_\_\_ or \_\_\_\_\_.
3. What are the basic types of an assurance engagement?
4. In the case of the audit of financial statements of banks, there is usually a paragraph, stating \_\_\_\_\_ of BOFIA and/or CBN circulars, if any.

## 7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountants of Nigeria. (2004). *Advance Audit and Assurance*. Lagos: ICAN.

Izedonmi, P. F. (2001). *Auditing and Investigations: Questions and Suggested Answers*. Benin City: UNIBEN Press.

## **MODULE 2      PUBLIC SECTOR AND SPECIALISED AUDITS AND INVESTIGATION**

|        |                                    |
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| Unit 1 | Ministries and Government Agencies |
| Unit 2 | Audit Procedures                   |
| Unit 3 | Specialised Audit 1                |
| Unit 4 | Specialised Audit 2                |
| Unit 5 | Investigation                      |
| Unit 6 | Insolvency                         |

### **UNIT 1      MINISTRIES AND GOVERNMENT AGENCIES**

#### **CONTENTS**

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| 3.1 | Public Sector Audit                                 |
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| 3.3 | Audit of the Treasury Accounts                      |
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#### **1.0      INTRODUCTION**

Auditing is as essential in the public sector as it is in the private sector. Section 85 of the 1999 Constitution, states that there shall be an Auditor-General for the Federation. The role of the Auditor-General is to ensure that there is accountability by the Executive arm of the Government to the Legislative arm, for the proper administration of the activities, functions, operations and programmes of the government and its various agencies.

#### **2.0      OBJECTIVES**

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

- State the categories of Government auditing
- Discuss the functions of the Auditor-General for the Federation
- Outline the various department of the office of the Auditor-General for the Federation

- State the functions of the Treasury Department
- explain the classification of accounting units of ministries and extra-ministerial departments
- state the objectives of auditing the accounts of Government parastatals.

### **3.0 MAIN CONTENT**

#### **3.1 Public Sector Audit**

Government auditing can be divided into three major categories, namely:

- (a) Audit of the Treasury Accounts, as prepared by the Accountant-General of the Federation
- (b) Audit of Ministries/Departments and Agency Accounts
- (c) Audit of accounts of parastatals.

Apart from the provisions of the 1999 Constitution, the Audit Act, 1958 also provides that the Accountant-General of the Federation should furnish the Auditor-General for the Federation with the country's financial statements within seven months after the close of each financial year.

The institutional arrangements put in place to enhance planning, budgeting, funding, accounting, reporting, auditing and reviewing of the revenue and expenditure of the Federal Government consist of the following:

- (a) Minister of finance who issues financial warrants with which the Accountant-General releases funds to the Ministries and Extra-Ministerial Departments, after approval by the legislature. The Minister can withhold any item of expenditure on which he/she so desires to exercise control.
- (b) Accountant-General of the Federation who is the only officer authorised to deal directly with the Central Bank of Nigeria. He/she releases funds to the Ministries and Extra-Ministerial Departments, based on the amount stated on the financial warrant signed by the Minister of Finance. He is also responsible for supervising all the treasury accounts and preparing all the necessary financial statements.
- (c) Auditor-General for the Federation is responsible for auditing the Accounts of the Federal Government and reporting to the National Assembly.
- (d) Public Accounts Committee (PAC) which is a committee of the National Assembly is responsible for public accounts in

accordance with section 85(5) of the 1999 Constitution. The PAC is required to deliberate on the Auditor-General's report, consider all the queries raised by him in his report, compile a comprehensive report and recommendation for submission to the whole House.

At the state level, a similar arrangement is also in place with the Commissioner for finance, Accountant-General of the State, Auditor-General for the state and the Public Accounts Committee of the State House of Assembly performing similar roles as their counterparts at the Federal level. The State Governor is empowered to appoint the Auditor-General for the State on the recommendation of the State Civil Service Commission, subject to confirmation by the State House of Assembly (Section 126 of the 1999 Constitution).

### **SELF-ASSESSMENT EXERCISE**

Outline the three categories of government auditing.

### **3.2 Auditor-General for the Federation**

The Auditor-General for the Federation shall be appointed by the President on the recommendation of the Federal Civil Service Commission, subject to confirmation by the Senate (Section 86 of the 1999 Constitution).

The Audit Act, 1958 provides that the Auditor-General for the Federation shall audit the accounts of all accounting officers and of all persons entrusted with the collection, receipt, custody, issue or payment of Federal Public monies or with the receipt, custody, issue, sale, transfer or delivery of any stamps securities, stores of other property of the Government of the Federation.

He is responsible for carrying out surveys of the cash, stamps, securities, stores or other properties of government that are held by such officers or persons. The Auditor-General shall examine the accounts relating to public funds and property, ascertain whether the objectives of government auditing are met and ascertain whether in his opinion:

- (a) The accounts relating to public funds have been properly kept;
- (b) All public monies have been fully accounted for and the rules and procedures applied are sufficient to secure effective check on the assessment, collection and proper allocation of revenue;
- (c) Essential records have been maintained and the rules and procedures applied are adequate to safeguard and control public property and funds; and

- (d) Monies have been expended for the purposes for which they were appropriated and the expenditures have been made as authorised.

In addition to being responsible for the auditing of the accounts of the accounting officers and all persons entrusted with various assets of government, the Auditor-General may also undertake the examination of the accounts of any organisation that receives funds from the government, such as statutory corporations, parastatals and voluntary agencies. For the purpose of performing such functions, the Auditor-General or any person authorised by him shall have access to all the books, records, returns and other documents relating to those accounts. In the exercise of his functions under the 1999 Constitution, the Auditor-General shall not be subject to the direction or control of any other authority or person.

### **Functions of Auditor-General for the Federation**

The functions of the Auditor-General for the Federation include the following:

- (a) Auditing and reporting in respect of treasury accounts, accounts of ministries/extra-ministerial departments and accounts of parastatals
- (b) Detection and prevention of fraud
- (c) Control of loss of funds by ensuring that effective internal control systems are in place
- (d) Serving as Chairman of the Audit Alarm Committee and Chairman of the losses Committee; and
- (e) Being in attendance during Public Accounts Committee sessions as an adviser.

### **Departments under Auditor-General's Office**

The Auditor-General's office is organised in such a way as to enhance the performance of his numerous functions. Consequently, the office is divided into the following departments:

- (a) Ministerial department: This consists of divisions to take care of treasury accounts, self-accounting ministries and offices, states and Abuja, defence and security, revenue, losses and investigation, pensions (civil/military) and annual report/public accounts committee.
- (b) Extra-ministerial department: This comprises divisions to handle public enterprises, universities and polytechnics, research institutes, river basins and rural development authorities, teaching

- hospitals and financial houses, mines and power and miscellaneous, and property and other voluntary organisations;
- (c) Personnel management department: This handles recruitment of staff, establishment, staff discipline, promotion, staff welfare, staff training and development
  - (d) Finance and supply department: This takes care of accounts, budgets, stores and protocol and miscellaneous
  - (e) Project monitoring and evaluation department and internal audit unit; and
  - (f) Planning, research and statistics department: This comprises planning, research, record and statistics, library and efficiency units.

The Auditor-General shall, within ninety days of receipt of the Accountant-General's financial statements, submit his reports under Section 85 of the 1999 Constitution to each House of the national Assembly and each House shall cause the Public Accounts Committee to consider the reports.

### **SELF-ASSESSMENT EXERCISE**

Outline the departments under the office of the Auditor-General for the Federation.

### **3.3 Audit of the Treasury Accounts**

The treasury department is headed by the Accountant-General of the Federation. He is also the treasurer and the Financial Adviser of the Federal Government [Finance (Control and Management) Act, 1958]. The functions of the Treasury Department includes the following:

- (a) It is the custodian of the Consolidated revenue Fund, Development Fund, Contingency Fund and other Public Funds of the Federation
- (b) It is responsible for recording the financial transactions of the government and reporting thereon through the production and publication of the annual financial statements of the Federal Government in a manner that will show a true and fair view of the financial position of the Federal Government
- (c) It manages the Federation accounts and their disbursements to the three tiers of government
- (d) It supervises the accounts of all the Ministries and extra-ministerial departments and issues circulars to them on government accounting and financial control matters

- (e) It is responsible for staff training and development of accountants, accounting and auditing personnel from the three tiers of government
- (f) It is responsible for revenue monitoring and accounting in Ministries and Extra-ministerial departments to ensure that the necessary internal controls are in place; and
- (g) It initiates and formulates financial and accounting policies for the Federal Government.

The Accountant-General's financial statements consist of eleven (11) main financial statements and twenty-five (25) supporting and sub-supporting statements. The eleven (11) main financial statements are as follows:

| Statement No | Description of Statement  |
|--------------|---|
| 1.           | Public debt   |
| 2.           | Assets and Liabilities  |
| 3.           | Consolidated revenue fund   |
| 4.           | Development fund  |
| 5.           | Treasury funds  |
| 6.           | Special and trust funds   |
| 7.           | Other loans and investments   |
| 8.           | Losses of government funds and stores   |
| 9.           | Revenue abandoned during the year   |
| 10.          | Guarantees of the Federal Government of loans to statutory corporations, etc. |
| 11.          | Arrears of revenue as at the end of the year.                                 |

The main objectives of auditing of treasury accounts are to ascertain whether:

- (a) The financial statements have been prepared in accordance with generally accepted government accounting principles; and
- (b) The information contained in the financial statements is properly classified, reliable, accurate and complete.

The audit of the accounts and financial statements prepared by the Accountant-General is carried out through the Federal Sub-Treasury as a function under the Treasury accounts Division of the Ministerial Department in the office of the Auditor-General for the Federation.

### **SELF-ASSESSMENT EXERCISE**

What are the functions of the treasury department?

### 3.4 Audit of Ministries/Departments and Agency Accounts

The Minister or Commissioner (at the State level) is the Chief Executive of each Ministry while the Permanent Secretary is the Accounting Officer who is empowered to deputise for the Chief Executive whenever the former is away from office.

In the extra-ministerial departments and agencies, the head of department is the accounting officer. Each ministry or extra-ministerial department also has a finance and supplies department (now Finance and Accounts from October 2001, headed by a Director) and subdivided into two divisions (Accounts Division and Supply Division). One of the functions of the accounts division is the submission of financial statements to the Treasury in the form required and reconciliation of the Ministry's Below-the-line accounts, that is, Non-budgetary accounts balances with Treasury's corresponding balances. Each Ministry or extra-ministerial department is regarded as an Accounting Unit for the purpose of processing accounts in the public sector. Accounting Units are classified into the following three groups:

- (a) Self-Accounting Units
- (b) Non-Self Accounting Units
- (c) Sub-Accounting Units.

#### Self-Accounting Units

These are ministries or extra-ministerial departments where the accounting functions are delegated to the Accounting Officer and are therefore, required to:

- (a) be approved by the Ministry of Finance to be a Self-Accounting Unit
- (b) write an Accounting Manual or Code which must be approved by the Accountant-General and Auditor-General
- (c) establish an Internal Audit Department
- (d) operate a Central Pay Office; and
- (e) operate two current bank accounts with the Central Bank of Nigeria, one for revenue account and the other for capital expenditure.

The documents to be submitted to the Accountant-General of the Federation by a self-accounting unit consist of the following:

- (a) Transcripts, that is, monthly accounts by way of control sheets
- (b) Voucher schedules
- (c) Duplicate copies of vouchers

- (d) Duplicate copies of vouchers relating to other ministries where original copies are for State Government
- (e) Certificate of cash and bank balances; and
- (f) Bank reconciliation statement.

Examples of self-accounting units are all Federal and State Ministries.

### **Non-Self Accounting Units**

These are ministries or extra-ministerial departments which are required to maintain complete record of 'Below-the-line' payments and receipts (salary advance accounts) but incomplete records of the 'Above-the-line' (budgetary account) payments and receipts. Consequently all the financial transactions of this type of unit are conducted through the Federal Sub-Treasury of Federal Pay Office in the State; to which payment vouchers are presented for checking and payment. Revenue received by this type of unit is paid into the account of the Sub-Treasury or Federal Pay Officer and it is the latter who renders his accounting return (including those of the non-self-accounting units do not render transcripts to the Accountant-General.

Examples of non-self-accounting units are the Federal Ministries located in any state of the Federation.

### **Sub-Accounting Units**

These are Ministries and Extra-Ministerial Departments where the accounting functions are delegated to the accounting officer but the officer is required to render monthly accounts to the Accountant-general not in details but in Sub-head aggregate form, accompanied by the original vouchers. These units are also required to:

- (a) be approved by the Ministry of Finance to be Self-Accounting Unit
- (b) write an Accounting Manual or Code which must be approved by the Accountant-General and Auditor-General
- (c) establish an Internal Audit Department
- (d) operate a Central pay Office; and
- (e) operate two current bank accounts with the Central bank of Nigeria, one for revenue and the other for capital expenditure.

However, the documents to be submitted by these units include the following;

- (a) Transcripts
- (b) Vouchers in support of the transcripts in original and duplicate

- (c) Copies of vouchers relating to its own Head in support of monthly transcripts; and
- (d) Schedule of expenditure not in details but in Sub-head aggregate form.

Examples of sub-accounting units are Federal Pay Offices, Customs Area Offices and Police pay offices.

Monthly transcripts should be audited by the auditor-general's staff before being sent to the Treasury.

### **Objectives of Auditing Ministries, Departments and Agencies**

The main objectives of auditing the accounts of Ministries/departments and Agencies are to ascertain whether:

- (a) all receipts of money emanating from the operations of the period under review are collected and properly accounted for
- (b) the accounting system in operation provides financial information that is reliable and free from material errors to facilitate the preparation of the accounting and financial statements required by law
- (c) the activities and programmes are conducted and expenditure are made in an effective, efficient and economical manner and in compliance with the requirements of applicable laws and regulations
- (d) the Ministry/department or Agency under focus is carrying out only those activities or programmes authorised by the National assembly and is conducting them in the manner contemplated to accomplish the objectives intended
- (e) the resources of the Ministry/Department or Agency, including funds, property and personnel are adequately controlled and utilised in an effective, efficient and economical manner; and
- (f) the accounting and financial statements presented to the prescribed authorities, that is, the Accountant-General, disclose properly the information required to various groups of both internal and external users.

There are appropriate divisions in the office of the Auditor-General for the Federation to handle the audit of various types of Ministries/Departments and Agencies. These include the following:

- (a) Revenue Audit Division to handle the audit of all revenue earning ministries/departments; for example, federal Ministry of Petroleum Resources, Customs and Excise, Federal Inland Revenue Service

- (b) Self-Accounting ministries/departments division of the Auditor-General's Office. This Division is responsible for the audit of the transactions and accounts of self-accounting ministries/departments. Examples are Ministry of Education, Ministry of communications; and
- (c) Defence and Security Division responsible for the audit of the transactions and accounts relating to the ministry of Defence, the Armed Forces of the Federation, Police and other Security agencies of Government.

The Internal Audit Department/Unit of any Ministry/Extra-Ministerial Department or agency (depending on whether they are self-accounting or sub-accounting units) is responsible for the pre-payment audit of all the financial transactions of the organs of government. The Chief Internal Auditor of the self-accounting organs is responsible to the Accounting Officer; he is required to submit to him and the Auditor-General for the Federation, the following documents:

- (a) Detailed audit programme
- (b) Monthly internal audit report; and
- (c) Half-yearly internal audit report.

The third type of report should also be submitted to the Accountant-General of the Federation. The Accounting officer of each ministry or extra-ministerial department is required, by the provisions of Financial Regulations 2201, to ensure that subject to the availability of staff, an Internal Audit Unit is established to provide a complete and continuous audit of the accounts and records of revenue, expenditure, plant, allocated stores, and unallocated stores where applicable.

### **Duties and Responsibilities of Government Internal Audit Units**

The general responsibilities of the Internal Audit Units at the various levels of Government, as contained in the existing Financial Regulations are to:

- (a) carry out continuous examination of all accounting books and records maintained by the Ministry/department
- (b) determine the adequacy of the Internal control system;
- (c) ensure that an adequate system of securities exists in the ministry/department
- (d) check all payment vouchers originating from any section of the ministry/department before payments are made
- (e) check the reliability of the accounting and reporting systems;
- (f) carry out any special review or assignment which may be required by management; and

- (g) cooperate with and assist the office of the Auditor-General for the Federation in making available necessary documents for the final audit of the establishment.

### **SELF-ASSESSMENT EXERCISE**

What are the responsibilities of Government Internal Audit Units?

### **3.5 Audit of Federal Government Parastatals**

Federal parastatals or public sector enterprises originated from public authorities, which are governmental units, “created to perform a single function or a restricted group of related activities. Usually such units are financial from service charges, fees and tolls, but in some instances they also have taxing powers” (Hay, 1980). They are organisations set up by government for different reasons, most importantly to perform social tasks. Some of them are set up to accomplish some purposes which ministries/extra-ministerial departments and agencies are not adequately equipped to accomplish, examples of this type are water, sewage, electric and gas utilities, airports, seaports, hospitals, schools, transportation systems, public housing projects and in Nigeria such organisations include PHCN, NIPOST, NITEL, Nigerian Railway Corporation, Federal Housing Authority and Nigerian National Petroleum Corporation.

Other types of parastatals are industrial core projects which are capital intensive enterprises, established predominantly by Government to produce basic inputs for downstream industries. These include refineries and petrochemical plants, fertilizer plants, steel plants, cement plants and liquefied natural gas (LNG) project.

Government parastatals are referred to variously as Corporations, for example, Nigerian Railway Corporation, Nigeria Ports Authority, Boards (State Waste Disposal Boards), Commissions such as Independent National Electoral Commission and National Population Commission. Each of the parastatals was created by an enabling Act that provides for its statutory duties and functions. In cases where they are floated as limited liability companies, they are either wholly owned or partly owned by Government. In the latter case, Government has majority or controlling interest in such limited liability companies. Some of the Government parastatals have been or are in the process of being privatised or commercialised.

### **Objectives of Auditing Government Parastatals**

The objectives of auditing the accounts of Government parastatals are to ascertain whether:

- (a) proper accounting records are being kept
- (b) all revenue items are duly collected and properly accounted for;
- (c) adequate controls exist to ensure the safety and proper use of the organisation's funds and assets
- (d) the organisation's management comply reasonably with the general level of probity and public accountability
- (e) the organisation's chief executive and other top management carry out only those functions and operations for which the corporation is established
- (f) proper accounts are being prepared in accordance with the financial and accounting clauses as provided for in the respective legal instruments setting up the corporation; and
- (g) the audited financial statements reflect a true and fair picture of the activities of the Board or Corporation for a particular period.

Section 85(3) of the 1999 Constitution provides that the Auditor-General for the Federation shall not audit the accounts of or appoint auditors for Government statutory corporations, commission, authorities, agencies, including all persons and bodies established by any Act of the National Assembly, but the Auditor-General is authorised to:

- (a) Provide such bodies with:
  - i. A list of auditors qualified to be appointed by them as external auditors and from which the bodies shall appoint their external auditors, and
  - ii. Guidelines on the level of fees to be paid to external auditors.
- (b) Comment on their annual accounts and auditors' reports thereon.

The Auditor-General, however, shall have power to conduct periodic checks of all these Government parastatals [Section 85(4)]. It is clear, therefore, that the audits of the parastatals are carried out by the firms of professional accountants in accordance with the 1999 Constitution. Such audited accounts, signed by the Board of the parastatals, along with the auditor's domestic reports on them are forwarded to the Auditor-General for the Federation for vetting. Therefore, he certifies the accounts which are subsequently submitted to the National Assembly, with his certificate and report known as "Auditor-General's Certificate" and "Auditor-General's Report" respectively.

The parastatals prepare accounts in accordance with the applicable generally accepted accounting principles relating to their forms. Thus, if they are outright limited liability companies, their accounts are prepared in accordance with the provisions of the Companies and Allied Matters Act Cap. C 20, LFN 2004 and the audit of their financial statements is carried out as in the case of other companies. However, for the other types of parastatals, fund accounting system is reflected in their accounts, as they receive subventions or grants from Government.

The parastatals are self-accounting units. The main accounts prepared by them consist of:

- (a) Receipts and payments account – This is similar to the cash account in the private sector.
- (b) Income and expenditure account – This is similar to the profit and loss account in the private sector. It reflects all the internally generated funds the subventions and grants received from Government. The account records all expenditure incurred by the corporation;
- (c) Balance sheet – it shows the financial position of the parastatal as at the end of a specified financial period. The balance sheet is also referred to as a statement of assets and liabilities;
- (d) Notes and schedules to the accounts – These are meant to explain or give additional information on the items in the income and expenditure account and balance sheet.

### **SELF-ASSESSMENT EXERCISE**

What are the objectives of auditing government parastatals?

## **4.0 CONCLUSION**

In each State, the Office of the Accountant-General of the Federation has either a federal Sub-Treasury or a Federal Pay Office; the Office of the Auditor-General for the Federation has a branch office in each State of the Federation.

The officers of the Auditor-General for the Federation at the State level are referred to as the Federal Auditors to distinguish them from the Internal Auditors who are the staff of the Internal Audit department of the Ministry/Department or Agency. The Officers audit Federal Establishments at the various States, such as Federal Pay Office.

## **5.0 SUMMARY**

In this unit, we discussed public sector audit; the office of the Auditor-General for the Federation; the audit of the Treasury account; audit of Ministries/Departments and Agency accounts; and audit of Federal Government parastatals.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. What is self-accounting unit?
2. What is non-self-accounting unit?

## **7.0 REFERENCES/FURTHER READING**

Institute of Chartered Accountants of Nigeria.(2004). *Advance Audit and Assurance*. Lagos: ICAN.

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## **UNIT 2     AUDIT PROCEDURE**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Public Sector Audit Procedures
  - 3.2 Specialised Public Sector Audits
  - 3.3 Types of Public Sector Audit
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing public sector audit procedures; specialised public sector audits; and types of public sector audit.

### **2.0 OBJECTIVES**

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

- outline the procedures adopted in respect of revenue, vote book, contract, cash book and control of security documents
- discuss audit relating to pensions, defence and security agencies, Nigerian Foreign Missions and contracts
- state and explain the various types of public sector audit.

### **3.0 MAIN CONTENT**

#### **3.1 Public Sector Audit Procedures**

Some procedures are peculiar to public sector accounts. Examples of these peculiar procedures are in respect of the following:

- (a) Revenue
- (b) Vote book
- (c) Contract
- (d) Cash book; and
- (e) Control of security documents.

As documented by Daniel (1999), audit procedures in respect of each of the above are briefly outlined below:

## Revenue

The following steps should be taken to audit the revenue collected on behalf of Government.

- (a) Conduct a cash survey on the revenue collectors, who is an officer entrusted with official receipt or licence book for the regular collection of a particular form of revenue from the public and is required to keep a cash book. (The prescribed receipt to be issued by him is treasury receipt book 6 – TR. 6).
- (b) Obtain and ascertain all receipts issued to the revenue collector after the last audit.
- (c) Trace all the triplicate copies of receipts into the revenue cash book maintained by the revenue collector.
- (d) Cast the cash book to ensure that no mistake has been made.
- (e) Verify the total collection as recorded in the revenue cash book with the TR 6 pasted on the cash book for evidence of payment to the main cashier.
- (f) Examine the bank tellers and confirm at the Central Pay Office (CPO) that all cheques received have been correctly and completely recorded.
- (g) For tenement rates, obtain copies of the latest assessment notice and list of outstanding from the previous year.
- (h) Evaluate the system of internal control for the handling of all receipts of revenue.
- (i) Ensure generally that:
  - i. The classification of revenue is in accordance with the year's estimates
  - ii. Receipts are issued for all money collected and such receipts bear the stamp of the office of issue
  - iii. All entries in the cash book include the dates and numbers of all receipts
  - iv. Revenue collectors do not make any payment out of the money collected by them
  - v. Revenue collectors submit their cash books and receipt books for examination to the Sub-Treasurer
  - vi. The Accounting Officer prepares regular returns of revenue arrears; and
  - vii. Where paper money (bank notes, cheques, postal order and money order) is received by post, such should be entered in a paper money register under the supervision of the officer opening incoming mails in the Ministry. Therefore, the register together with the remittance should be passed to the cashier who will issue the receipts or

- licences in respect of the amount and record them in his cash book.
- viii. Spot audit checks of revenue collected are conducted.

### **Vote Book**

The audit procedures for Departmental Vote Allocation Books (Vote Books) in the public sector are stated below.

- (a) Obtain the approved estimates for various Heads and Sub-heads;
- (b) Obtain copies of the Financial Warrants/Authority to incur Expenditure (AIE) issued to the Ministry/Department
- (c) Post the Warrants to the Vote Book to ensure that there is authority for the entries made
- (d) Ascertain the officers who are authorised to control and spend the Votes
- (e) Ensure that all vouchers, including the liabilities, are posted to the Vote Book
- (f) Ensure that correct adjustments are made in the “balance available” column whenever the actual cost is greater or less than the liability figure already noted
- (g) Ensure that no unauthorised liability or expenditure is incurred and that over expenditure is avoided
- (h) Ensure that each entry is initialled by the authorising officer;
- (i) Check all the various instruments of virements
- (j) Ensure that where there is a mistake, the entry is reversed in red or black ink as applicable; and
- (k) Ensure that all outstanding liabilities at the end of the financial year are cleared as indicated in Financial Regulation 521.

### **Contract**

The procedures for the audit of contract accounts are as follows:

- (a) Check contract agreements with the minutes of the Tender Board meetings
- (b) Open the contract register and update it for control purposes
- (c) Ensure that interim payments are in accordance with the contract agreements
- (d) Examine the completion certificates to ensure that payments are made on the appropriate certificates given
- (e) Conduct physical inspection of work done to ensure compliance with terms of contract and completion of work certificates given;
- (f) Ensure that the correct retention fee is retained; and
- (g) Ensure that all necessary deductions are made before payments are made on each occasion that they are authorised.

### **Cash Book**

The following procedures shall apply when auditing the cash book of the Pay Office, Central Pay Office or Cashier in the Treasury of a Local Government:

- (a) Conduct a cash survey to verify if the cash book (cash column) agrees with the physical cash produced for survey
- (b) Trace the receipt vouchers (TR 6) to the cash book and ensure that all of them have been correctly posted
- (c) Verify revenue collected and paid to bank by reference to the bank tellers
- (d) Ensure that the cash book contains individual treasury numbers;
- (e) Trace the payment vouchers to the cash book serially and ascertain that all postings are accurate and complete
- (f) Ensure that all the cheque numbers (where applicable) are correctly indicated in the cash book
- (g) Ensure that the amount on each cheque is equal to the corresponding voucher and that the cheque number is written on the corresponding voucher; and
- (h) Cast the cash book, ensuring that every brought-forward and carry-forward balances from one folio of the book to the other are correctly transferred and cover the entire audit period.

### **Control of Security Documents**

The following steps should be taken to audit the security book register in order to ensure control of the various types of security documents used by government:

- (a) Check if orders for new supplies of cheques or printing of receipts are authorised by the designated officer in the Finance Department
- (b) Ensure that all deliveries of new supplies are recorded in the appropriate register, for example, cheque stock register or security book register
- (c) Check that all issues from stock are recorded in the appropriate security book register and signed by authorised recipients
- (d) Request to see all cancelled cheques for audit inspection
- (e) Ensure that all the security documents whether currently in use or not are kept in a safe under lock and key; and
- (f) Ensure that there is a prior written approval/consent of the Accountant-General of the Federation for the transfer of receipt books between any two Sub-Accounting Officers.

## **SELF-ASSESSMENT EXERCISE**

Outline the procedures adopted in respect of revenue, vote book, contract, cash book and control of security documents.

### **3.2 Specialised Public Sector Audits**

The public sector consists of various areas needing special attention by virtue of the mode of operations involved in their activities. This section covers the audit of such areas as:

- (a) Pensions audit
- (b) Audit of defence and security agencies
- (c) Audit of Nigerian Foreign Missions and Agencies; and
- (d) Audit of contracts or projects.

#### **Pension Audit**

The audit of the payment of benefits to qualified officers is primarily aimed at ensuring that the claims of retiring officers such as gratuities and pensions for both civil servants and military personnel are carefully monitored and approved for payment by the office of the Auditor-General for the Federation before such claims are paid. Hence it takes a fairly long time to get all the documentations completed and payments authorised.

This audit is handled by the Pension Division of the Ministerial Department in the office of the Auditor-General for the Federation. The first stage of payment of gratuity is approved after the Federal Audit, on receipt of the retiring officer's file and computed benefits from the Pensions office has:

- (a) Verified the debt statement from the details of the officer's indebtedness to Government; and
- (b) Examined the benefit payable to check if it is in compliance with the relevant latest schedule.

Thereafter, for the commencement of the payment of monthly pension, the Pensions Sections forwards the following documents to the Federal Ministry of Establishments and Management Services:

- (a) Completed pension forms
- (b) Certified true copy of record of service
- (c) Debt clearance certificate
- (d) Photocopy of letter of promotion to the last grade
- (e) Photocopy of letter of notice of retirement and acceptance

- (f) Quadruplicate cope of payment voucher
- (g) Quadruplicate copy of computation sheet examined by the Federal Audit; and
- (h) Three recent passport photographs.

The essential point here is that once the Federal Audit had examined the retiring officer's computation sheet and approved, it is certain that adequate measures have been taken to prevent overpayment of benefits to such an officer.

It is worthy of note that Section 173 of the 1999 Constitution provides that pensions shall be reviewed every five years or together with any Federal Civil Service salary reviews, whichever is earlier; and that pensions in respect of service in the public service of the Federation shall not be taxed.

### **Audit of Defence and Security Agencies**

The transactions and accounts of the Ministry of Defence and Security Agencies (such as the Nigerian Police Force and the Armed Forces of the Federation) are audited by the Defence and Security Division under the Ministerial Department of the Office of the Auditor-General for the Federation. The affairs of these offices have been covered under the audit of the accounts of ministries/extra-ministerial departments and agencies. The affairs of these offices are also applicable to the audit of Defence and Security Agencies. The provisions of the 1999 Constitution on the Police (Section 214-216) and the Armed Forces (Section 217-220) are pertinent for all audit staff to note.

### **Audit of Nigerian Foreign Missions and Agencies**

In view of the economic and political interdependence of Nations, each country has adopted foreign policies to guide its relationship with others. This gives way to the need to have foreign Missions and Agencies in these other countries. These foreign mission and agencies are used to aid the relationship of each Nation with another.

In Nigeria, there are various Embassies and High Commissions headed by Ambassadors and High Commissioner respectively. The latter is used to describe the offices in countries that are members of the Commonwealth of Nations. In return, Nigeria also has Embassies and High Commissions abroad. In addition, Nigeria also has foreign Missions, for example, Permanent Mission of Nigeria to the United Nations (based in New York).

These foreign missions and agencies are supervised by the Federal Ministry of Foreign Affairs. Therefore, the Head of the Internal Audit in the Federal Ministry of Foreign Affairs is charged with the responsibility of conducting the audit of the foreign missions and agencies from time to time. In addition to the activities of the internal audit department of the Federal Ministry of Foreign Affairs, the office of the Auditor-General for the Federation also sends audit staff to these foreign missions and agencies for the purpose of conducting the audit of their financial operations and accounts.

### **Audit of Contracts or Projects**

Though, the procedure for the audit of contracts has been covered under Section 15.6, the current attention being given to audit of contracts is to emphasise that there is a division (Project Audit Division) under the Project Monitoring and Evaluation Department of the Office of the Auditor-General for the Federation. This division embarks on a comprehensive or value-for-money audit of some selected large government contracts or projects. The audits carried out on these selected projects are usually detailed and inclusive of investigations with a view to ascertaining whether government has derived value for the money spent on them.

### **SELF-ASSESSMENT EXERCISE**

Discuss audit relating to foreign missions and contracts.

### **3.3 Types of Public Sector Audit**

The functions and scope of responsibilities of the Auditor-General for the Federation and those of his counterparts in other parts of the world have shown that these are about three main types of audit in the public sector. These three types emanated from the fact that the primary objective of the public sector is not to generate profit but to render services. These audit types are:

- (a) Regulatory audit
- (b) Financial audit; and
- (c) Value-for-money audit.

#### **Regulatory Audit**

This type of audit (otherwise referred to a Compliance Audit) is conducted with a view to ensuring that expenditure has been incurred on approved services and in accordance with the enabling statutory provisions and regulations governing the particular expenditure. The

following are the documents that the auditor of a public sector organisation may require in conducting a compliance audit:

- (a) The Nigerian Constitution (latest edition)
- (b) Civil Service rules
- (c) Treasury Circulars
- (d) Establishment Circulars
- (e) Official Gazettes of Government
- (f) Financial Instructions
- (g) Budgets; and
- (h) Financial Acts.

An example of this type of exercise is the audit conducted on each project or contract.

### **Financial Audit**

Financial audit is one that is conducted in order to ensure that the accounting and financial control systems are efficient and cooperating properly; and that financial transactions have been correctly authorised and accounted for. In other words, it is to ensure that the financial statements and accounts have been prepared to present a true and fair view of the state of affairs of the establishment concerned and in respect of the period covered by the audit.

This is the type of audit conducted on the treasury accounts of the Federation from time to time.

### **SELF-ASSESSMENT EXERCISE**

State and explain the various types of public sector audit.

## **4.0 CONCLUSION**

The peculiarities of public sector accounting make the procedures required for the audit to be peculiar to some extent. There are certain procedures of auditing in the public sector which are similar to those in the private sector, such as the verification of assets and store audit.

## 5.0 SUMMARY

- In this unit, we discussed public sector audit procedures, specialised public sector audits and the various types of public sector audit.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Outline the procedures adopted in respect of revenue, vote book and contracts in government auditing.
2. Discuss audit in relation to defence and security agencies.
3. State and explain the various types of public sector audit.

## 7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountants of Nigeria. (2004). *Advance Audit and Assurance*. Lagos: ICAN.

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## **UNIT 3      SPECIALISED AUDIT 1**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Value-For-Money (VFM) Audit
  - 3.2 Due Process Review
  - 3.3 Public Sector Investigations
  - 3.4 Recent Developments
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall discuss value-for-money audit, due process review, public sector investigations, and recent developments.

### **2.0 OBJECTIVES**

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

- state the elements of Value-For-Money (VFM) audit
- outline the techniques for carrying out a VFM audit
- highlight the problems of VFM audit
- discuss the procedure for carrying out public sector investigation
- explain the major characteristics of the use of a probe panel
- state the duties of the Independence Corrupt Practices and Other Related Offences Commission
- state the responsibilities of the Economic and Financial Crime Commission.

### **3.0 MAIN CONTENT**

#### **3.1 Value-for-Money Audit**

The scope of governmental auditing has been widened over the years by the demand for independent verification of information to the extent that it can no longer be limited to the audit of financial operations. As far back as 1972, the Comptroller-General of the United States had stated that:

Instead, governmental auditing now is also concerned with whether governmental organisations are achieving the purposes for which programs are authorised and funds are made available, are doing so economically and efficiently, and are complying with applicable laws and regulations (Comptroller-General of the U.S., 1972, p.3).

In the same vein, the Green Paper on the Role of the Comptroller and Auditor-General (Cmnd 7845) in the United Kingdom had stipulated as far back as 1980 that government auditing can be categorised into financial audit, regulatory audit, economy and efficient audit, and effectiveness audit.

The audit objective has been viewed traditionally as an independent examination of the financial statements of an entity followed by the expression of opinion as to the truth and fairness of the financial statements against the criteria of generally accepted accounting principles and standards. However, in the case of government accounting, the general absence of the profit motive and the presence of the provision of social and economic services have combined to extend the audit objective to include an ascertainment of whether the establishment being audited is achieving the purposes for which its programmes are authorised and whether it is doing so economically, efficiently and effectively.

Value-for-money is the concept that seeks the maximisation of the use of scarce resources for the welfare of the public by ensuring that activities and programmes are carried out at low cost and to high standard. In order to achieve this phenomenon, three elements are usually covered and these are: economy, efficiency and effectiveness. These were the key elements of the views expressed by both the United States Comptroller-General and the United Kingdom Comptroller-General and Auditor-General about three decades ago.

The value-for-money audits suggest those procedures designed to assist management establish necessary controls to ensure that the desired objectives are met at the desired level of efficiency and effectiveness. Though this emphasises cost savings but that may not be the overriding objectives. VFM may be applied to both private and public enterprises, but it is particularly relevant in the public sector. Its application in the public sector is designed to provide to the oversight bodies an assessment of the performance of the operating arm with information, observations and recommendations designed to promote answerable, honest and productive government. It encourages accountability and best practices.

The procedure for VFN is to assess the economy, efficiency and effectiveness with which government acquires and applies resources to benefit and wellbeing of the citizens. Economy does not necessarily imply the cheapest price while the measure of effectiveness is subjective, often involving the perception of the recipients of Government services. The value-for-money audit may be sensitive to certain political realities such as labour agitation. For instance, where the VFM review clearly reveals overstaffing in public service, some other non-financial considerations may shape Government's reaction to a recommendation to down-size staff strength. However, a VFM review will certainly focus on the areas of:

- (a) corporate structure
- (b) information systems
- (c) management style
- (d) authorisation procedures
- (e) segregation of duties
- (f) resource utilisation; and
- (g) effective supervision.

### **Elements of Value for Money**

According to Afemikhe (2003), the three elements of value-for-money, i.e. economy, efficiency and effectiveness can be described as follows:

#### **(a) Economy**

This is the practice by management of the virtues of thrift and good housekeeping. An economical operation acquires resources in appropriate quality and quality at the lowest cost.

#### **(b) Efficiency**

This is to make sure that the maximum useful output is gained from the resources devoted to each activity, or, alternatively, that only the minimum level of resources are devoted to achieving a given level of output. The efficiency of an operation could be said to have increased if either lower costs were used to produce a given amount of output, or a given level of cost has resulted in increased output.

#### **(c) Effectiveness**

This ensures that the output from any given activity is achieving the desired results. There is, therefore, the need to establish that the desired goals are being achieved in order to evaluate effectiveness.

The type of interrelationship among these three elements is that all of them should be in place before the assessment of value-for-money can be said to be complete. Right things should be done, using the right method and at minimum cost. For instance, as much as effectiveness is linked with the achievement of set objectives, it is also important to expect that the objectives are achieved by the application of the right methods, that is, efficiently – the use of a sledgehammer to kill a housefly, though effective, is not efficient!

The application of value for money concept to auditing leads to the concept of value-for-money (VFM) audit. It is applicable to both the private and public sector, but more emphasis has been placed on its application to the public sector. VFM audit recognises that the primary responsibility for securing value for money lies with the management of the spending agency or establishment. Developed countries have given legislative backing to VFM audit while such backing is found to be lacking in developing countries. For instance in Nigeria, Johnson (1999) stated that:

Value-for-money audit is currently the subject of much discussion in the public sector, some taking the view that it represents a new concept... (Johnson, 1999, p.83).

In seeking if the 1999 Constitution has made any legislative commitment to the concept of VFM audit, Afemikhe (2004) concluded that:

It can be seen from the above that the 1999 Constitution did not expressly empower the Auditor-General to carry out value for money audits (Afemikhe, 2004, p.40).

In spite of the poor state of legislative commitment to VFM audit, it has been observed that the Auditor-General for the Federation has included it in his scope of responsibilities. VFM audit is carried out with adequate consideration for economy, efficiency and effectiveness in its quest for resource management. It is related to the extent to which funds are spent economically, efficiently and effectively. It is also referred to as Comprehensive Audit or Efficiency Audit.

Johnson (1999) opined that VFM auditing is a blend of both conventional auditing, that is, as far as economy and efficiency are concerned and management consulting (in the area of effectiveness audit). In countries where there are specific statutory provisions, on the functions of the government auditor, the responsibilities of the Auditor-General are well stated to include VFM whereas in the absence of such

provisions, the Auditor-General will at best be doing what he understands to be his responsibilities. Consequently the audit queries issued to the Accounting Officers may be misconstrued and not treated in the most appropriate manner.

### **VFM Audit Techniques**

The techniques for carrying out a VFM audit can be outlined as follows:

- (a) Analysis of performance indicators such as financial ratios and unit costs of the establishment, with comparative figures for the previous periods and in respect of similar establishments. A trend analysis should be done, and significant differences highlighted through the trend analysis should be investigated further. This initial analysis is aimed at identifying the areas that need specific attention.
- (b) Management and systems review for the purpose of investigating the ways in which objectives are established, policies implemented and results monitored. This will enable the VFM auditors ascertaining how efficiently these processes have been carried out without necessarily having to concern themselves with the review of the objectives and policies themselves.
- (c) Analysis of planning and control processes for the purpose of ascertaining how the establishment has been monitoring performance against the plan, reviewing and reporting its operating results, and how members and officers have been alerted of the need for remedial action whenever required. An example is checking how the Vote Book has been used in controlling planned expenditure.
- (d) Efficiency Assessment may involve specific investigation into a few activities with high unit cost, or poor performance measures or suspected poor management with a view to ascertaining the reasons for the adverse performance indicators and identifying the appropriate remedial action.
- (e) Effectiveness review for the purpose of ascertaining whether or not the activities or programmes are achieving the objectives for which they have been undertaken. This usually involves discussions with service managers and committee members on the details of each particular activity especially regarding why the activity is undertaken, why it is done in the way it has been done, what other alternatives have been considered and why such other alternatives have been rejected and how performance is measured.
- (f) Reporting on the VFM audit- it is very important to discuss the draft report in detail with the officers (service managers) and committee members before it is finalised and presented.

(Adapted from Johnson, 1999, pp.85-6).

### **Value-for-Money Review Teams**

Value-for-money review teams can be used to conduct performance review in government offices and parastatals. These teams are either on full-time or part-time basis. Though the large organisations may have adequate resources to justify a full-time VFM review team, there are arguments against having such a team, for instance, one major disadvantage of having a full-time VFM Unit is that the staff are often reluctant to submit recommendations that could affect the career of their colleagues negatively, that is, fellow officers or on sensitive issues.

An example of an organisation that has an in-house value-for-money committee structure is the Nigerian National Petroleum Corporation (NNPC). This corporation has a three-tier VFM committee structure in the review of its upstream joint venture companies. As reported by Afemikhe (2004, pp 232-3), these committees are:

- (a) an operational value-for-money committee within National Petroleum Investment Management Services (NAPIMS) – an NNPC Strategic Business Unit that works on a day to day basis with the joint venture companies. This committee reports directly to NAPIMS chief executive
- (b) a technical value-for-money committee at the Corporate level which liaises with the NAPIMS Value-for-Money Auditors on technical value for money matters and reports to the Corporate Value for Money Audit Committee; and
- (c) a Corporate Value for Money Audit Committee which is headed by a Group Executive Director and reports directly to the Group Managing Director and the Group Executive Committee.

There is an increasing use of external consultants to serve as independent value for money evaluators or auditors. The advantage of this is the possibility of drawing from a wide range of specialists, non-inhibition about drawing attention to sensitive issues or negative impact on colleagues' career, and provision of an objective viewpoint anchored on a diversity of experience.

### **Areas of Waste in the Public Sector**

These are numerous areas of waste in the public sector which require elimination if value-for-money is to take a deep root in the affairs of government. These areas will serve as a guide for VFM auditors as they will be able to identify where to pay attention when undertaking efficiency assessment and effectiveness review. The areas include but are not limited to the following:

**(a) Manpower**

- i. Employment of more staff than required for the operational needs of the organisation
- ii. Employment of wrong persons for the right job
- iii. Employment of the right person for the wrong job thereby leading to manpower underuse; and
- iv. Retention of redundant staff.

**(b) Purchasing and Materials Management**

- i. Overpricing of purchases
- ii. Purchasing of poor quality materials through deliberate adulteration of materials or deliberate wrong definition of specification
- iii. Procurement of obsolete materials and equipment; and
- iv. Dumping by export companies of substandard equipment and materials with the connivance of top management staff
- v. Procurement of spare parts for items of equipment that have been phased out, resulting in difficulties with subsequent maintenance
- vi. Issuance of incorrect inspection certificate by procurement or import supervision officers
- vii. Deliberate refusal to maintain sound inventory control procedures, even when the procedures are in place; and
- viii. Existence of surplus or obsolete materials in every site or store
- ix. Additional purchases of stock lines with no historical evidence of usage
- x. Holding of stock of materials transferred to operational stock from construction parts leftovers, commissioning parts leftovers, and bulk parts left unused; and
- xi. Continuous procurement of spares for an item of equipment that has long been scrapped resulting in acquisition of materials that the organisation has no need for.

**(c) Motor Vehicle and Transport**

- i. Not taking advantage of fleet discount resulting from the use of unnecessarily wide range of vehicle types and suppliers
- ii. Not having a clear policy on boarding of vehicles resulting in excessively high maintenance cost being incurred on vehicles

- iii. Idle fleet of vehicles and misuse of vehicles as a result of having too many vehicles
- iv. Lack of vehicle maintenance policy that leads to uncontrolled maintenance costs; and
- v. Not taking full advantage of fleet insurance.

**(d) Landed Property**

- i. Owning more landed property than required for operations and not taking any steps to enhance the earning capacity of the excess property
- ii. Having government officials on transfer staying in hotels and guest houses for an unduly long period of time; and
- iii. Simultaneous occupation of multiple official accommodations by some senior government officials in different locations of the Federation.

**(e) Fund Management**

- i. Poor treasury management, for example, surplus cash and investment
- ii. Lack of asset management policies, for example, credit policy, policies on debt recovery and on monitoring of the age profile of overdue debts; and
- iii. Lack of borrowing policy to provide for negotiation of loans and overdrafts in order to reduce the overall interest burden on the organisation's total borrowing.

**Problems of VFM Audit in the Public Sector**

The following problems have generally been associated with the application of VFM audit in the public sector:

- (a) Inadequacy in the means of measuring the corporate objectives in the public sector. To what extent is the welfare of the public maximised?
- (b) Lack of a complete view of the report of activities and state of affairs in the public sector resulting from the non-use of accrual basis of accounting.
- (c) Continuous gap in professional skill requirements for the Auditor-General's Office.
- (d) Inadequacies in the accounting and internal control systems in the public sector.
- (e) Lack of commitment to the overall achievement of goals by the managers in the public sector.

## SELF-ASSESSMENT EXERCISE

Explain the elements of value for money

### 3.2 Due Process Review

On a continuous basis and in both the private and public sectors, efforts are usually made, to seek improvement on the way activities are carried out, if there is to be progress in the results being sought to be achieved. More importantly, in the public sector, those at the helm of affairs should make deliberate efforts to improve on the systems already put in place in all the three tiers of government if they must remain relevant in the global village which the world is turning into.

The concept of control as applicable to the public sector has been undergoing various changes from one country to the other and in the recent past. Each nation has been formulating policies aimed at improving resources utilisation at the budget implementation stage. Considerable efforts have been made to find new techniques of control and to introduce institutional changes and improvements to the types of controls applied.

In an effort to exercise control on the expenditure of Government, it is not sufficient to rely on the fact that the expenditure items have been provided for in the approved budget (via the Appropriation Act). At the implementation stage, approval for releasing the money should be tied to availability of funds through the extent to which the revenue budgeted for has been earned. Therefore, the process of controls involved under the overall expenditure control structure should cover monitoring of the activities, for example, contract, approval for payment and release of funds. There should be commitment by the top management staff at the relevant tier of government to the new ways of doing things.

In Nigeria, the relatively long period of military rule had almost eroded the basic economic structures that had been developed since independence. Consequently, in return to democratic rule in 1999, the Federal Government emphasised that the administration adopts transparency, equity, justice and accountability as its guiding principles and policy imperatives. These principles are to ensure commitment to public policies and good governance. There has been a constant effort at applying a new managerial outlook to controls, which in turn according to Nwankwo (2004) includes:

- (a) specification of standards and measures of performance
- (b) emphasis on output controls
- (c) greater competition in the public sector; and

(d) more focus on discipline and economy in resource use.

One of the key issues towards which the Federal Government has directed tremendous energy, attention and resources is that of corruption. Conscious of the enormous negative impact of corruption on the Nation, the administration set out to evolve various policies targeted at eliminating corruption, each time supporting such policies with appropriate political will. All the policies adopted against corruption have been “shaped by a thorough appreciation of the root causes of corruption, the factors that nurture it, the forces that support and benefit from it, as well as comparative analysis with other societies and nations which have had similar experiences like ours” (Ekaette, 2001). Ekaette stated further that:

“Yet another source which has been identified as providing a basis for widespread public sector corruption is the massive expansion in public procurement. To control this problem, a battery of new systems and processes have now been introduced. These include a comprehensive system of Due Process to deal with the problem. Major revisions in the Financial Regulations of the Public Service have been made. The objective of the policy in this area is to achieve value-for-money in the areas of Public Sector procurement and thereby eliminate rampant corruption which has rendered prices of basic purchases by government in Nigeria as one of the highest in the world” (Ekaette, 2001).

#### **Establishment of the Budget Monitoring and Price Intelligence Unit (BMPIU)**

It has always been a recurrent observation of those reviewing the budgetary performance of Government in Nigeria that implementation is our problem. The problems experienced during implementation may as well have originated in formulation.

Therefore, the axiom “prevention is better than cure” could be appropriate here. It is on the basis of this view that evaluation of completed programmes and projects were initiated as an ex-post control but with an impact that goes beyond the budget implementation phase. The evaluation consists of an assessment of progress and its impact, so that areas of success and failure in implementation can be identified. It is a process aimed at the following:

- (a) Examining the programme rationale
- (b) Achievement of objectives
- (c) Cost of achievement; and
- (d) Exploration of alternatives. (Nwankwo, 2004, p.32)

Evaluation in the context of the above explanation serves mainly to link formulation and implementation of budgets and is used by the executive. It is also possible to view evaluation as a tool for ensuring both transparency and accountability. It was in recognition of this that President Olusegun Obasanjo formally established the Budgeted Monitoring and Price Intelligence Unit (BMPIU) in June 2003 and appointed the Senior Special Assistant on Budget Matters, Mrs Oby Ezekwesili as the Head of the Unit.

The Head of the BMPIU is responsible for the effective implementation of the budgetary due process programme of the Obasanjo administration. This task involves ensuring strict compliance with laid down rules and procedures guiding the process of contract invitation, contract award and project implementation. This is with a view to ensuring that Government's resources are managed in such a way that they are not wasted.

The BMPIU has become synonymous with Due Process. In fact, it has come to be known as the Due Process Unit because of the emphasis on the need to follow due process in all the different tiers of Government and all the parastatals. It is noteworthy that the term "due process" simply means the appropriate way or proper method or expected approach or normal way of doing something. It is, therefore, merely an awakening or revival of the application of the procedures already put in place earlier but for some time abandoned due to corruption and moral decadence.

### **Objectives of BMPIU**

The objectives of BMPIU are to:

- (a) Harmonise existing government policies/practices and update same on public procurement
- (b) Determine whether or not Due Process has been observed in the procurement of services and contracts
- (c) Introduce more honesty, accountability and transparency into the procurement process
- (d) Establish and update pricing standards and bench-marks for all supplies to government
- (e) Monitor the implementation of projects during execution with a view to providing information on performance, output and compliance with specifications and targets; and
- (f) Ensure that only projects which have been budgeted for are admitted for execution.

The BMPIU operates under four main areas as follows:

- (a) Regulatory functions
  - (b) Certification functions
  - (c) Monitoring functions; and
  - (d) Training and advisory functions
- A. The Regulatory functions consist of the following:
- i. Regulating and setting standards, including the enforcement of harmonised bidding and tender documents
  - ii. Formulating of the general policies and guidelines related to public sector procurement
  - iii. Developing, updating and maintaining a related system wide database and technology
  - iv. Undertaking procurement research and survey in order to determine information need and project costing; and
  - v. Enforcing professional ethics and sanctioning erring officers and professionals.
- B. The certification functions include:
- i. Certifying all Federal Government procurements under the following guidelines
  - ii. Resident Due Process Team Certification for projects below N50 million and
  - iii. Full Due Process Certification for projects above N50 million at various stages such as “contract award certificate” and “payment certificate”.
- C. The monitoring functions comprise the following:
- i. Supervision of the implementation of established procurement policies
  - ii. Monitoring of the prices of tendered items
  - iii. Performing procurement audit
  - iv. Undertaking the monitoring of capital projects that have exceeded 50% of contract sum before release of further funds; and
  - v. Documentation of all projects at award and completion stages, and publishing same in designated journals.
- D. The training and advisory functions include the following:
- i. Co-ordination of relevant training programmes so as to build institutional capacity;

- ii. Embarking on regular public enlightenment programmes aimed at sensitising various stakeholders involved in procurement; and
- iii. Interacting with Government and parastatal officials, National Assembly members, consultants and relevant professional bodies in order to educate them on all aspects of the work of BMPIU.

### **Procedure for Due Process Review**

The procedures for Due Process Review are as follows:

#### **(a) Meeting the requirements for Due Process Review**

**The beneficiary Ministry should submit the following documents:**

- i. The project policy file
- ii. Tender returns
- iii. Tender evaluation report
- iv. Contract award letter and agreement
- v. Original contract bills of quantities, if any
- vi. Contract drawings, if any
- vii. Other contract documents
- viii. Financial summary and statements
- ix. Progress reports
- x. Variation reports and variation orders arising; and
- xi. Interim valuation and certificates.

#### **(b) Preliminary Discussion between MBPIU and Beneficiary Ministries.**

It may become necessary to schedule meeting between BMPIU and beneficiary ministries or parastatals. Such meetings are aimed at clearly issues connected with the report for certification or to obtain more information to facilitate the issuance of certification.

#### **(c) Preparation of Draft Report**

The Due Process Certification will require an assessment to ensure that:

- i. The appropriation is available for the funding requirements of the project upon award; and
- ii. The contract awarded by the spending unit/ministry shows that the process complies with open competitive bid standards and that the cost is comparable with national, regional and international standards.

**(d) Transmission of Draft Report**

The draft report from BMPIU shall be transmitted to the beneficiary confirming certification. If certification is not granted, attention of the beneficiaries is drawn to the finding findings and recommendations in the report.

**(e) Organisation of “Right of Reply” Meeting**

For a project where certification is defined, BMPIU has made provisions for a “Right of Reply” meeting aimed at clarifying issues leading to the denial of certification. Such a meeting may either lead to reconciling differences or confirming the position of BMPIU.

**(f) Final Report**

The outcome of a “Right of Reply” meeting will assist in fine-tuning the report and facilitating the issuance of a final report.

**(g) Granting or Denying Due Process Certification**

The final report may either lead to the project being granted certification or being denied certification. Whatever the outcome, it will be transmitted to the beneficiaries.

The granting of certification may lead to the project being recommended for approval by the Federal Executive Council. In cases where projects are denied certification, the beneficiaries may be advised to repackage the project for fresh procurement.

**Impact of Due Process Review**

The impact of the Due Process Review has been reported felt at all levels of government (Federal, State and Local) and even in the parastatals. Some of the salutary effects are as follows:

- (a) Recognition of only competent contractors who go through the due process
- (b) Elimination of “middlemen” such as consultant in contract awards
- (c) Re-instatement of rightful contract winners who had been formerly denied contracts
- (d) Restoration of confidence to many local and foreign companies that could not carry on in the former corruption-ridden culture that had characterised the award of government contracts

- (e) Massive savings through the reduction in contract sum of the contracts reviewed by the unit. For example, as much as N125 billion in the first two and a half years of operation; and
- (f) Improvement in revenue collecting units of government. For example, the Federal Inland Revenue Services (FIRS), Nigerian Customs and Excise and other parastatals that have resorted to following the laid down rules and procedures of carrying out their operations.

### **SELF-ASSESSMENT EXERCISE**

What is due process review?

### **3.3 Public Sector Investigations**

Though the affairs of Government (at the different levels) may have a focus that differs from what the private sector managers consider as their primary objective, when it comes to losses of Government fund or suspected fraud, there are laid down procedures for conducting the required investigation. The main difference between the public and private sectors in this regard is the timing of the investigation in relation to the time of occurrence of the event; it is usually the case that the gap between the occurrence of event and action on investigation is usually longer in the public sector related cases. The main reason for this could be attributed to the bureaucratic structure in the public sector.

#### **Power to Conduct Investigations in the Public Sector**

Section 88 of the 1999 Constitution provides the each House of the National Assembly shall have power, by resolution published either in its journal or in the Federal Government official Gazette, to direct or cause to be directed an investigation into:

- (a) Any matter or thing with respect to which it has power to make laws; and
- (b) The conduct of affairs of any person, authority, ministry or government department charged, or intended to be charged, with the duty of or responsibility for:
  - i. Executing or administering laws enacted by the National Assembly; and
  - ii. Disbursing or administering monies appropriated or to be appropriated by the National Assembly.

**The purpose for directing such an investigation is to enable the National Assembly to:**

- (a) Make laws with respect to any matter within its legislative competence and correct any defects in existing laws; and
- (b) Expose corruption, inefficiency or waste in the execution or administration of laws within its legislative competence and in the disbursement or administration of funds appropriated by it.

Section 128 of the 1999 Constitution provides each State House of Assembly with similar powers to conduct investigation for purposes similar to those for which the National Assembly can conduct investigation.

In addition to the power of the legislative arm of Government to conduct investigation, the executive arm of Government can also conduct investigation through its public service structure. This can be done by both the Auditor-General for the Federation and the Accountant-General of the Federation.

In the office of the auditor-General for the Federation, there is the Losses and Investigation Division under the Ministerial Department. This division is responsible for carrying out detailed investigation into suspected cases of loss of funds, monitoring developments in the treatment and procedure followed on confirmation of cases of loss of funds, and supplying information needs of the Losses Committee.

In the office of the Accountant-General of the Federation (who is the Head of the Federal Treasury Department), there is the Treasury Inspectorate Department under which there is an investigation section. The Treasury Inspectorate Department is responsible for oversight functions of the Treasury on accounting and financial control matters. Investigations handled by this section are, as indicated by Daniel (1999), those that may arise from the following:

- (a) Discoveries from routine examination and inspection of accounting records in Ministries/Departments
- (b) Internal Audit reports
- (c) Reports of the Auditor-General for the Federation
- (d) Newspaper publications and other news media information;
- (e) Direct personal information on suspected or known fraud or requests by Ministries/Departments
- (f) Suspicion based on alteration or falsification of records; and
- (g) Petitions and anonymous letters.

In addition of the Investigation section, there is also the Permanent board of Survey and Inquiry section under the Treasury Inspectorate Department. The accountant-General is empowered to order the Board of inquiry to be convened on the request of the Accounting Officer. The Board is convened when there is a loss of government fund, for the purpose of carrying out investigation into the circumstances of the loss of the funds as well as the causes and perpetrators of such loss or fraud.

### **Procedure for Carrying out Public Sector Investigations**

The procedure for conducting investigations in the public sector varies according to the type of investigation being conducted. The variation is purely in terms of the extent to which evidence may be taken and the extent of power bestowed on the body set up for conducting the investigation. Some of the procedures are discussed below:

As regards the investigations that could be conducted by the National Assembly, Section 89 of the 1999 Constitution states the power as to matters of evidence (which brings out clearly the procedure to be followed) as follows:

- (a) The Senate or the House of Representatives or committee appointed to conduct investigation shall have power to:
  - i. Procure all such evidence, written or oral, direct or circumstantial, as it may think necessary or describable, and examine all persons as witnesses whose evidence may be material or relevant to the subject matter
  - ii. Require such evidence to be given on oath
  - iii. Summon any person in Nigeria to give evidence or produce any document in his possession or under his control; and
  - iv. Issue a warrant to compel the attendance of any person who refuses to attend after being summoned, and order such a person to pay all costs associated with having to compel his attendance.
  
- (b) Such a warrant or summons issued in this case may be served or executed by any member of the Nigeria Police Force or any person authorised in that behalf by the President of the Senate or the Speaker of the House of Representatives, as the case may be.

Section 129 Of the 1999 Constitution contains similar provisions for power as to matters of evidence bestowed on each State House of Assembly or its committee as regards the conduct of investigation.

What is easily discernible from the above is the fact that there will be appointment of the members of the committee with clearly stated terms of reference. The committee, guided by the terms of reference and supported by the powers bestowed on it, can then proceed to gathering appropriate information and evidence to enable it come to reasonable conclusions. This is followed by the writing and submission of its report.

In the case of the Treasury Inspectorate Department of the Federal Treasury, whenever a case is to be investigated, at least two investigators are appointed in order to allow the report of one investigator to corroborate the report of the other. The investigation will involve:

- (a) Examination of records
- (b) Making extracts from relevant documents
- (c) Making visits to various places that are connected with the case;
- (d) Interrogating persons that are connected with the case; and
- (e) Writing and submission of the Investigation Report.

The investigation report should be comprehensive enough and include recommendations as to whether the case should be referred to the Board of Survey and Inquiry, or where such referral is not necessary, the sanctions to be meted out to the erring officers and possible improvement in the internal control system to prevent a recurrence of similar cases.

Cases that are referred to the Board of Survey and Inquiry are at the instance of the Accountant-General, who is empowered to request the Secretary, Board of Survey and Inquiry to convene the Board of Inquiry on the request of the Accounting Officer. Once requested to convene the Board, the Secretary's convening order is required to contain the terms of reference for the board as may be advised by the Accountant-General.

**The Secretary to the Board Ensures that he Forwards Copies of the Convening Order to the Following Public Officers**

- (a) Accountant-General of the Federation
- (b) The Federal Ministry of Finance
- (c) Auditor-General for the Federation
- (d) Chairman, Federal Civil Service Commission; and
- (e) The relevant Accounting Officer.

**The Board is required to do the following:**

- (a) Commence the investigation as soon as the Board is convened;

- (b) Hold the meetings of the Board without any delay;
- (c) Direct all its enquiries toward discovering any weakness in the accounting system;
- (d) Inform the Accountant-General and Federal Ministry of Finance of all the facts relating to the circumstances of the loss without delay by means of an interim report; and
- (e) Prepare and submit the final report.

**The Final Report of the Board of Inquiry shall include the following:**

- (a) Re-statement of the terms of reference
- (b) A statement on the exact amount of loss that has been incurred;
- (c) An opinion on whether the operation of the accounting system in the office concerned is faulty or not
- (d) An opinion on whether the accounting system in the office concerned is appropriate or not, with suggestions on any practicable remedial measures
- (e) An opinion on whether the physical security measures in place have been considered adequate or not, with suggestions on how to improve them if found inadequate
- (f) Assessment of the degree of negligence of the officers considered responsible for the loss; and
- (g) Recommendations of the appropriate sanctions for the loss including responsibility for full or partial recovery of the loss.

It in the process of investigation, the matter is reported to the police, the Board shall defer its final deliberation and recommendations until the police investigation is completed.

Thereafter, the Board shall include in its consideration of any relevant police report or court proceedings in its own final report and recommendations.

**Use of Probe Panel in Investigating Fraud and Corruption**

The 1999 Constitution, as its predecessors, has some provisions on the Code of Conduct expected to be observed and conformed to by all public officers at the three tiers of Government as well as in the parastatals (Sections 172, 209). The Code of Conduct is contained in the Fifth Schedule to the Constitution. The meaning of misconduct as implied in the Code of Conduct and the powers of the Code of Conduct Tribunal are also indicated. Misconduct is stated in the Code of Conduct as meaning:

breach of the Oath of Allegiance or Oath of Office of a member or breach of the provisions of the Constitution or a misconduct of such nature as amounts to bribery or corruption or false declaration of assets and liabilities.

In the past, it was usual for the executive arm of Government to set a panel of enquiry (popularly referred to as a Probe Panel) for the purpose of inquiring into a matter with a view to ascertaining the extent of fraud and/or corruption perpetuated and those responsible for it. This is different from the Code of Conduct Tribunal. Such a probe is usually handled by a panel consisting of professional experts, usually involving a judge as chairman and other members including an accountant.

**The Major Characteristics of the use of a Probe Panel include:**

- (a) Appointment of panel members, specifying the chairman and the secretary
- (b) Letter of appointment in which the terms of reference are clearly stated
- (c) Indication of the scope of the probe assignment should be clearly indicated in the brief for the probe, usually in writing
- (d) Preliminary sittings to set out how to carry out the assignment
- (e) Call for memorandum from the public, indicating the format, deadline for submission of same and addresses to which they should be sent
- (f) Requesting the persons suspected of fraud and/or corruption to appear before the Panel with written submissions of their involvement with the case
- (g) Public Hearings (at places and on dates clearly stated and communicated to the members of the public) during which oral presentations could be taken
- (h) Invitation of person, officials, experts and auditors considered relevant to the case being probed to give evidence to the Panel on dates and at places clearly communicated to them
- (i) Examining the evidence obtained and searching deeply into the areas requiring additional attention; and
- (j) Writing of the report for submission to the person that appointed the Panel; if it is a body corporate the report should be submitted to its management.

**The Report of the Probe Panel should include the following:**

- (a) Reference to the letter of appointment and the terms of reference
- (b) The mode of operations of or the method used by the Panel to conduct the investigation or probe

- (c) The extent of evidence gathered and any limitations encountered
- (d) The findings especially the fraud or extent of corruption that has been discovered
- (e) The identity of those found guilty of the fraud or corrupt practices
- (f) The internal control weaknesses that facilitated the fraud and how the weaknesses can be eliminated from the system concerned
- (g) The effects of the fraud and/or corruption on the operations of the organisation concerned and the periods affected; and
- (h) The plea made by those found guilty and any amends that they have promised to make or have made.

### **SELF-ASSESSMENT EXERCISE**

Outline the procedure for carrying out public sector investigation.

### **3.4 Recent Developments**

In view of the determination of the Federal Government to eradicate corruption from all angles from both the private and public sectors, the Corrupt Practices and other Related Offences Act, 2000 (Anti-Corruption Act) was enacted, and the Independence Corrupt Practices and Other Related Offences Commission (ICPC) was established.

**The duties of the ICPC, as stipulated in Section 3 of the Anti-Corruption Act is as shown below:**

- (a) Receive and investigate any report and prosecute any person where reasonable grounds exist for suspecting that the person has conspired to commit or has attempted to commit or has committed an offence amounting to corruption
- (b) Examine the practices, systems and procedures of public bodies and where, in the opinion of the Commission, such practices, systems or procedures facilitate fraud or corruption, to direct and supervise a review of such systems
- (c) Instruct, advise and assist any officer, agency or parastatals on ways by which fraud or corruption may be eliminated or minimised by such officer, agency or parastatal
- (d) Advise heads of public bodies of any changes in practices, systems and procedures compatible with the effective discharge of the duties of the public bodies as the Commission thinks fit to reduce the likelihood or incidence of bribery, corruption and other related offences
- (e) Educate the public on and against bribery, corruption and other related offences; and
- (f) Enlist and foster public support in combating corruption.

The Anti-corruption Act has a comprehensive list of types of offences, which are punishable by imprisonment and fine, and their respective penalties. The offences could be summarised as consisting of:

- (i) any public officer giving, asking and receiving bribe/gratification
- (ii) any public officer inflating the price of any goods or services above the prevailing market price or professional standard
- (iii) any public officer awarding or signing any contract without budget provision, approval or cash backing
- (iv) any public officer transferring or spending any sum allocated for a particular project or service to another project or service
- (v) any public officer failing to report bribery transaction (Sections 23, 24)
- (vi) any persons who, with the intention of defrauding or concealing a crime or frustrating the Commission in its investigation, destroys, alters, mutilates, falsifies or omits any materials from any book, document, valuable security, account, computer system, diskette, computer printout or other electronic device of his employer (Section 15); and
- (vii) any person, who being an officer charged with the receipt, custody, use or management of any part of the public revenue or property, knowingly furnishes any false statement or return in respect of any money or property received by him (Section 16).

The ICPC since inception has been battling with the performance of its duties, prosecuting some public officials in various courts.

In 2003, the Federal Government established another anti-corruption agency, the Economic and Financial Crimes Commission (EFCC) followed by the enactment of the EFCC Act in year 2004.

**The EFCC is charged with the following responsibilities, among others:**

- (a) Enforcement and administration of the EFCC Act in the over-all context of preventing, detecting, investigating and prosecuting all cases of economic and financial crimes in Nigeria;
- (b) Enforcement of the provisions of other laws and regulations relation to economic and financial crimes including:
  - i. Money Laundering Act 1995, as amended

- ii. Advance Fee Fraud and Other Related Offences Act 1995;
  - iii. Failed Banks (Recovery of Debts)
  - iv. Banks and Other Financial institution Act 1991, as amended; and
  - v. Miscellaneous Offences Act 1985.
- (c) Being the key agency of government responsible for fighting terrorism and terrorist financing.

**Section 46 of the EFCC Act defines economic and financial crimes to mean:**

“the non-violent criminal and illicit activity committed with the objective of earning wealth illegally either individually or in a group or organised manner thereby violating existing legislation governing economic activities of Government and its administration and includes any form of fraud, narcotic drug trafficking, money laundering, embezzlement, bribery, looting and any form of corrupt malpractices, illegal arms deal, smuggling, human trafficking and child labour, illegal oil bunkering and illegal mining, tax evasion, foreign exchange malpractice including counterfeiting currency, theft of intellectual property and piracy, open market abuse, dumping of toxic waste and prohibited goods, etc.”.

**SELF-ASSESSMENT EXERCISE**

State the major characteristics of the use of a probe panel.

**4.0 CONCLUSION**

You are advised to look at the publications on the anti-corruption crusade as well as the ongoing public sector reforms in order to be up-to date in their discussions of this matter.

An example is that of the House of Representative Committee on the Public accounts, ordering the Accountant-General of the Federation to probe the N25.8 billion pension disbursement in 2002 by the Directorate of Military Pension (DMP). The expenditure was made by the DMP without involving the office of the auditor-General for the Federation for proper monitoring as required.

**5.0 SUMMARY**

This unit has exposed you to the concept of value-for-money (VFM), its audit (in all ramifications) including guides to VFM audit teams so as to curb areas of waste in government spending.

The establishment of the Budget monitoring and price intelligence unit (BMPIU), also known as the Due Process Office, its procedures for review and overall impact on the economy was mentioned.

Investigations in the public sector and the use of probe panels have also been discussed. Attention has been given to the various attempts that the government has made to draw attention to the menace of misconduct and corruption with a view to curbing them both in the public and private sectors of the nation. Recent developments by Federal government, especially in the establishment of the two anti-corruption agencies, that is, the ICPC and EFCC, have also been highlighted.

However, it should be noted that the two main issues covered in this unit are topical issues that are constantly being reviewed and updated. You are therefore implored to obtain updated versions of the developments in the two areas of Due Process Review and Value-for-money audit from the internet publications of government; in order to remain conversant with latest developments

## 6.0 TUTOR-MARKED ASSIGNMENT

1. \_\_\_\_\_ system is reflected in the accounts of government parastatals that receive subvention or grant from government.
2. The three elements of a value-for-money audit are \_\_\_\_\_ , \_\_\_\_\_ and \_\_\_\_\_.
3. Value for money review teams can be engaged either on a \_\_\_\_\_ or \_\_\_\_\_ basis.
4. The Budget Monitoring and Price Intelligence Unit in the Presidency is otherwise referred to as the \_\_\_\_\_ office.
5. The \_\_\_\_\_ Division under the Ministerial Department in the office of the Auditor-General for the Federation is responsible for carrying out detailed investigation into suspected cases of loss of government fund.

## 7.0 REFERENCES/FURTHER READING

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## **UNIT 4 SPECIALISED AUDIT 2**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Audits of Different Types of Organisations
  - 3.2 Audit of Specific Organisations
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### **1.0 INTRODUCTION**

Specialised audit covers the audit of various types of organisations (profit and non-profit) and the different types of industries in the business group. In some cases, there are auditing standards and guidelines on specific areas, whereas in other cases, the auditor has to rely on his knowledge of the general approach techniques and the peculiarity of the organisation.

It is observed that even when there are auditing standards and guidelines applicable to specific industries; they tend to be long and complex. You should be familiar with the general approach to the special features and audit difficulties relating to the various types of organisations.

### **2.0 OBJECTIVES**

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

- outline the content of the records contained in the permanent audit files
- state some special features of audit relating to farmers, professionals, hospitals and hotels
- describe the items involved in the detailed examination of the financial statements of a university
- highlight the steps an auditor should take in the verification of the assets and liabilities of an insurance company
- outline the approach adopted by the auditor with respect to most charities;
- discuss what a joint audit is; and
- state the responsibilities/liabilities of the joint auditors.

### **3.0 MAIN CONTENT**

#### **3.1 Audits of Different Types of Organisations**

There are many types of organisations with each one of them having accounts prepared and most of them requiring that they should be audited. Some of these organisations are business organisations while others are non-business (or not-for-profit) organisations. Every type of organisation has its own peculiar audit problems emanating from the nature of business carried on.

Some enterprises are subject to specific statutory and regulatory requirement on how their accounts should be prepared and audited, such as banks, insurance companies, primary mortgage institutions, charities etc. While it will not be feasible to provide detailed discussion of how to do an audit for each and every organisation, a general approach which can be adapted to specialised organisations is provided in this section. Subsequent sections will provide hint on the audit of specific types of enterprise.

#### **General Approach**

The general approach to an audit which can be modified for handling any special type of organisation, consist of the following:

##### **(a) Setting up of a Permanent Audit File**

Permanent audit files contain records that do not change from time to time. Such records include:

- i. A copy of the rules or regulations, constitution or other document governing the specific enterpriser. For example, Memorandum and Article of Association for an incorporated entity, partnership deed or agreement in the case of a partnership
- ii. A copy of any statutory material relating to the conduct of the organisation, its accounts or its audit; for example, Companies and allied Matters Act (CAMA) for specialist incorporated bodies, CAMA and Banks and Other Financial Institutions Act (BOFIA) for banks, CAMA and Insurance Act for insurance companies, bye-laws for non-governmental organisations
- iii. The engagement letter
- iv. A copy of the minutes of the meeting at which the appointment of the auditor was approved
- v. Notes on the history of the organisation, its background, the industry it belongs to and its prospects

- vi. Notes on the internal structure of the organisation, its location(s), personnel, management, production systems, products/services, etc.
- vii. Copies of all prospectuses in respect of the organisation; and
- viii. A list of the organisation's advisers, which are bankers, solicitors, etc.

**(b) Planning of audit, taking into consideration and documenting the following:**

- i. Audit risk
- ii. Reliance on internal control (or not)
- iii. Substantive testing; and
- iv. Analytical review.

**Specific Approach to each Organisation's Audit**

The specific approach to the audit of any of these peculiar organisations could be as follows:

**(a) Accounting Policies**

Consider any problems of accounting measurement which may affect the organisation's accounts.

**(b) Assets and Liabilities**

Consider the types of assets and liabilities which are likely to be found and any particular problems which might arise in verifying their existence, ownership, valuation and presentation in the organisation's accounts.

**(c) Revenue and Expenses**

Consider the types of revenue and expense which might arise in controlling and recording them.

**(d) Internal Control**

Consider any special problems which might arise in respect of any of the transactions of the organisation. A likely area that will need attention is the handling of cash transactions (both receipt and payment).

**(e) Statutory Requirements**

Consider any accounting and/or auditing rules required by statute, that is, the audit of banks and financial institutions is governed not only by CAMA but also by the Banks and Other Financial Institutions act (BOFIA) 1991.

**(f) Regulatory Requirements**

Consider the requirement of any regulatory body for the organisation's accounting and auditing, such as, Central Bank of Nigeria (CBN) Act 1991 and Nigeria Deposit Insurance Corporation Act 1988 for banks and other financial institutions.

**(g) Audit Risk**

Consider any matters which might give rise to greater than normal audit risk. In some organisations, these matters might be in relation to valuation of stock and work-in-progress while in others they might be cash receipts or ascertainment of asset quality by financial institutions.

**(h) Auditor's Report**

Consider the form of report which should have the following sections:

- i. Addressee
- ii. Financial statements audited
- iii. Respective responsibilities of directors and auditors
- iv. Audited standards followed, for example, Nigeria Standards on Auditing
- v. The audited opinion, which is usually in terms of "true and fair view"
- vi. Any other opinion prescribed by statutory or other requirements, for example, Insurance Act in addition to CAMA
- vii. Identity of the auditor; and
- viii. Date of the report.

**SELF-ASSESSMENT EXERCISE**

Outline the content of the records contained in the permanent audit files.

**3.2 Audit of Specific Organisations**

As indicated in the ICAN professional examinations syllabus, the following specific industries shall be covered. In some cases, attention is drawn to their special features and specific audit difficulties:

## Special Features of Farmers, professionals, Hospitals and Hotels:

There are some industries that really have special features, which the auditor will need to be familiar with in order to carry out his work.

### **The special features include the following:**

#### **(a) Farmers**

Accounts of farmers vary according to the type of business organisations which are run, that is, sole proprietorship or company, the type or variety of products that the farm produces, as well as the extent of records being kept. The well-known types of farming include:

- i. Arable farming involving growing of crops
- ii. Pastoral farming involving livestock
- iii. Mixed farming involving both crops and livestock; and
- iv. Plantation farming involving planting of tree crops such as rubber, plantain, cocoa, palm tree, sugar-cane, etc.

There are also other features of farm accounts, for example, crop rotation resulting to “fallow crops” and “fallow period(s), valuation of livestock, government subsidies (if any) in respect of fertilizers and extension workers, and valuation of crops and stores at the end of the financial year.

Farmers usually operate as sole proprietors in which case a lot of the records may not be kept at all. Therefore, the auditor may have to treat the farmer’s accounts as those of a small business where he may be involved in converting incomplete records to “complete records”. This exercise involves having to prepare the trial balance and final accounts. On the other hand, if the farm is operated as a company, the provisions of CAMA are applicable in which case; the farmer will keep accounting records and prepare financial statements annually.

The knowledge of columnar and departmental accounts is used in respect of the variety of farm products that may exist, for example, crops, fruits, poultry, piggery, cattle, and fishery. As regards the valuation of the stocks of the various categories of the farm products, as at the end of the financial year, the provisions of *SAS NO. 4* as discussed in the subsequent unit are applicable.

#### **(b) Professionals**

There are many types of professionals in business, for example, accountants, lawyers, doctors, engineers, pharmacists and architects.

Some professionals carry on businesses as sole practitioners, partnerships and limited liability companies. It should however be noted that some professions are precluded either by law, or professional code of conduct, from being incorporated. Examples are firms of solicitors and accountants, as specified in Section 19 of CAMA.

In carrying out the audit of professionals, the auditor will need to consider the type of business organisational set up, the code of conduct of the particular profession and the statutory guidelines (if any) that may affect the profession.

### **(c) Teaching Hospital**

In addition to dispensing drugs and medical services at a price to patients (which would have been an ordinary business concern), a teaching hospital, as a complex organisation, carries out a lot of other activities and renders other specialised services to patients and the community, most of which are not-for-profit. It may also derive much of its income from diverse sources, some of which may be capital in nature including Government subventions, philanthropic organisations, donor organisations and individuals, research institutes, international agencies and charities. Special funds may also be provided for research and specialist health activities such as AIDS, tuberculosis or cancer.

The revenue from the ordinary activities of a teaching hospital may appear under the following headings:

- Consultation
- Drugs
- Surgery
- Nursing Care
- Bed Fee
- Feeding
- Delivery Charges
- Mortuary Fees
- Sale of Cards
- Laboratory Tests and
- Blood Infusion
- Dialysis

The following problems may be associated with the audit of a teaching hospital:

- i. Apart from analysing the changes to a patient into the appropriate headings, there is also the problem of matching costs with related revenue, especially in cases where a patient's admission extends from one accounting year to another. Hence, where the teaching hospital has the policy of receiving advance payments from patients, there is always the problem of apportioning such advance payments to the different periods to which they relate. The auditor should therefore, review the basis of the apportionment and carry out a re-computation of such accrued revenue in order to confirm the reasonableness and accuracy;
- ii. There is also the problem of high incidence of bad debts for a hospital establishment especially in cases of patients who die in the course of treatment. There is need therefore, for the auditor to carry out a review of debtors with a view to ensuring that adequate provision has been made for debts that may not be recoverable for whatever cause.
- iii. Owing to the peculiar nature of the services of a hospital, unavoidable weaknesses may exist in the internal control system. For instance, patients may be admitted at irregular hours like victims of road accidents or armed robbery attack that may arrive at odd hours of the night. It will be necessary, on that account, for the auditor to assess the procedure for dealing with such emergencies in order that they do not provide the avenue for loss of fund or failure to collect the related revenue.
- iv. A hospital, being a specialised establishment, is likely to have sophisticated equipment whose value may be out of proportion to the size and whose real value will depend on the condition of the asset. It will require specialised skills to determine the effect of obsolescence on this equipment.  
Furthermore, this equipment may have been avoided by philanthropic organisations, individuals or charities, some of whom may be foreign based. In such situations, it may be difficult to establish the full monetary value of this equipment for accounting purposes.
- v. Stocks will consist of drugs, dressing, consumable supplies and disposable items, some of which will have expiry dates. Apart from the problem of examining these items individually in order to determine the expiration dates, the auditor may lack the skills to determine the condition of the items; hence he may have to rely on the opinion of experts.
- vi. Apart from normal creditors for supplies made or services rendered, the liabilities of a hospital may include contingent liabilities of a hospital may include contingent liabilities for

pending litigation or claims for negligence arising out of faulty medical treatment or application of wrong drugs. In addition to identifying the existence of such claims, there is also the difficulty of estimating the value of the claims. The auditor should therefore make enquiry of officials and examine available correspondence to establish the existence of such claims and the possible value.

- vii. In addition to ensuring the truth and fairness of the financial statements, they may also be required to be in a particular format for presentation to the relevant supervising authority or donor agencies. The report may be addressed to the governing board with a copy to the supervising Ministry of Health.

#### **(d) Hotels**

The revenue of a hotel establishment will include accommodation for rooms, meals served in restaurants, bar sales for beverages and tobacco, sale of snacks, laundry services, hire of conference halls, telephone, fax and internet services, room service, car hire service. The sources of revenue for hotels are diverse and of non-standard value. For instance, hotel rooms are different classes and restaurant meals are based on the specific orders by guests who are required to be “costed” by attendance and attendants and waiters who may not have any accounting knowledge.

In order to carry out the audit of a large hotel establishment, the auditor should first identify all sources of revenue to the hotel and evaluate each in terms of control over the revenue generated. One major difficulty relating to the internal control of a hotel establishment is the unlimited hours of business.

Just as in the case of a hospital, guests may arrive at odd hours of the night. Furthermore, guests who have made deposits may fail to utilise the services paid for or may only utilise such services in part. This gives rise to complex computations of refunds which may be open to abuse.

The audit approach to be adopted for a hotel establishment will include the following procedure:

- i. In respect of guests for accommodation, the auditor should assess the check-in-procedure in order to ensure adequate control over:
  - Initial deposit required;
  - Billings for the rooms; and
  - Refunds for deposits not utilised.

- He should check the daily cash summaries and agree with the daily chart to confirm that guests have been billed as is appropriate. He should agree the daily collections with the relevant bank paying-in-slips to ensure that the day's collections have been paid intact into the bank account. He should agree the refunds made to the relevant bills and deposits and check the payments to the imprest cash books. For credit customers, he should identify the individual charges to the monthly bills.
- ii. In respect of restaurant services, he should ascertain the costing method for meals served and check the bills on a sample basis to the cash receipts book. He should agree individual bills to the menu and confirm calculations for additional charges such as service charge and VAT. He should ensure that the service charges, where applicable the room service, ensuring that this has been billed at the appropriate rate.
  - iii. The telephone and fax bills should be checked to the telephone log and traced there from to the individual guest bills.
  - iv. The hire of conference halls should be vouched by reference to the related correspondence in order to ensure adequate billing and effective collection.
  - v. The bar account should be verified by carrying out a physical stock check and overall test of the bar purchases and daily sales. The verification should follow the normal procedure for verifying purchases and sales.
  - vi. The assets and liabilities of the hotel are verified in the normal way. The assets will comprise mainly of vehicles furniture and equipment.
  - vii. The debtors for bills not yet paid are verified like any trade debtors, focusing particularly on the procedure for granting credit, the status of such debtor and the paying habit. Wherever necessary, the auditor should ensure that appropriate provision is made for debts that are doubtful of recovery.

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**(e) A University**

For the audit of a University, the auditor should consider the enabling legislation, the nature of its activities, the funding, the system of internal control, the accounting format and the reporting requirements. Universities in Nigeria are established by special Acts of the National or State Assemblies with approval for the various programmes by the National Universities Commission (NUC), a body also charged with the responsibility of funding and regulating activities of the universities. It will therefore be appropriate for the auditor to obtain copies of the Act setting up the university and the NUC accreditation of its programmes. On the first visit, the auditor should obtain a schedule of NUC subventions for comparison with the infrastructural developments.

Governmental organisations such as universities, health institutions and similar organisations are not subject to very stringent legal rules as the Government itself. The financial statements of such governmental organisations are required to provide information useful for making resources allocation or funding decisions, information useful for assessing services provided and the ability to provide such services, information for assessing management stewardship, performance and economic resources, obligations, net resources and changes thereto.

**i. Review of the System of Internal Control**

In the evaluation of the system of internal control as is applicable to a university, the auditor will consider the following factors:

- Methods of keeping records;
- Organisation structure;
- Segregation of duties; and
- Custodial controls.

**The Method of keeping Records**

Books and records which are kept for a university are: the record of fixed assets, the cash and bank books, the record of staff employment, students enrolment record, students' academic records, payroll record

and other expenditure. Proper internal control requires that these records are kept in a permanent form.

This means that all records that are of continuing importance should be either typed or written in ball point pen. In this age of computers, most records are stored electronically and similarly duplicated for safety and prevented from access to unauthorised persons.

Hence, proper internal control for auditing purposes precludes any records being kept in pencil. It is also necessary to ensure that these records are updated regularly and not allowed to fall into arrears. Proper reconciliation should be carried out between these records and any other relevant independent reports. For instance:

- the cash book should be reconciled with the bank statements
- the fixed assets register should be reconciled with the physical assets held by the transport or works department
- the library records should be reconciled with the physical stock of books. If such reconciliation is not done promptly and regularly, cases of malpractice or errors may remain undetected for a very long time. It should be noted that a usual method to conceal malpractices is to create chaos in the records by allowing them fall into arrears or setting them ablaze in extreme cases.

### **Organisation Structure**

In order to eliminate friction and promote efficiency, there should be a well-defined organisation structure. Not only that the positions and authority levels are well defined, competent staff should be assigned to specific positions of responsibility in respect of which they have the relevant skill.

Professors should be assigned to the academic and research departments, a doctor to the medical centre, an accountant to the bursary and an engineer to the works department. A well-defined organisation structure helps management to run the business in an orderly manner. This enhances operational efficiency, which is an important feature of internal control. It also eliminates unnecessary costs, which may be incurred as a result of internal role conflict.

Since internal control does not relate to any financial accounting matters, the auditor of a university should look out for the following in evaluating the system of internal control as it relates to the entity:

- The catering department for the procurement and distribution of meals in the cafeteria
- The student affairs for the control, administration and allocation of students accommodation
- The works department for the general administration, the allocation of staff quarters, vehicles and maintenance facilities.
- The library for the procurement custody and lending of books to students, staff and the general public
- The registry for student admission and general academic regulations
- The academic affairs department for graduate academic records and a lot more as the above is by no means exhaustive.

### **Segregation of Duties**

An important aspect of internal control is the segregation of duties. This does not relate to the division of duties as applicable in economics. That would have been taken care of by the organisation structure already discussed above. The segregation of duties as it relates to the University requires that no one person or department shall be responsible for the whole three aspects of any transaction (procurement) in the institution. These three aspects are Authorisation, Custodian and Recording.

For instance, for acquisition of a motor vehicle for the University, the office of the Vice-Chancellor authorises the purchase of the vehicle, the works department does the actual purchase and takes delivery, while the Bursar's office effects payment and keeps record of the vehicle. For student's fees, a bank may be designated to collect cash, the Bursary issues the official receipts and the Registry, student's affairs or the faculties carry out different aspects of student's clearance.

The simple objective of the segregation of duties is to ensure that no one person is in a position to both perpetrate a malpractice and at the same time conceal his action by manipulating the records. Hence, if collusion occurs between a student and a dishonest bank staff, and the former is able to obtain an invalid teller for fees paid, this will be detected by the Bursary at the time the official receipt is issued or at the time bank reconciliation is carried out. This principle of segregation of duties is extended to other aspects of the operations of a university like:

- government grants and other sources of generating funds to the university
- staff salaries, capital expenditure and other payments which the university undertakes
- students admissions, hostel accommodation and cafeteria
- examinations and academic records; and

- staff offices and housing allocation.

### **Custodian Controls**

In addition to the general rules (basic controls) which are in place to help ensure efficiency, the University should also establish additional rules (disciplines over basic controls), to ensure that the general rules it had established are indeed being complied with. These custodial controls are designed to physically prevent the loss of assets by ensuring that the general rules of internal control are indeed operating.

### **The following are policy actions designed to enforce discipline in any institution or public place:**

- The wire fencing or walling of the premises with only one entrance into the university
- All vehicles and individuals entering or leaving the university premises pass through the gate and are subject to security checks;
- You are required to drop hand bags and briefcases at the entrance before being admitted into the library
- The cash office is a cage whereby the cashier operates from behind an iron barrier with people paying and being paid cash through a slot.
- Entry into the store is prohibited to “unauthorised persons”;
- Cheque books, LPOs and other sensitive documents are locked up in a safe or fire proof of cabinets in the custody of responsible officials;
- Stocks of unissued certificate should be locked in vaults preferable with a bank or the Nigerian Security and Minting Company.

### **Analytical Review of the Financial Statements**

The second stage of the audit of a university is the analytical review of the financial statements. This review is designed to ensure that the financial statements are properly drawn-up and show a true and fair view. This is the statutory responsibility on which the auditor’s report is based.

Having carried out a review of the system of internal control in the university, the auditor has a good idea of the strengths and weaknesses in the control. The strengths relate to those areas in respect of which the controls are operating and which may therefore be relied upon. The weaknesses relate to those areas in respect of which the controls are non-existent or where they exist but fail to operate.

These are the areas which the auditor identifies as potential germinating soil for malpractices or errors. At the end of the review of the system of internal control, the auditor sends a management letter, otherwise called “letter of weakness”.

In it, the auditor points out to the authorities:

- the specific areas of weaknesses
- their possible effects on the financial statements or likely losses which they may occasion; and
- the remedial action needed to put these matters right.

In relation to a university, the letter should be addressed to the Chief Executive (the Vice Chancellor), after being discussed in detail with the Bursar. The likely points on such a letter are:

- improper or incomplete recording of students’ fees
- staff salaries prepared in a manner likely to lead to duplications or introduction of non-existent workers
- improper accounting for fixed assets for instance if a fixed assets register is not maintained
- improper physical control of fixed assets which may lead to misuse or even loss of those assets
- non-reconciliation of bank statements; and
- payments made on the basis of improperly authorised vouchers, and cheques issued not being restrictively crossed, etc.

Based on the strengths and weaknesses identified and communicated to the Chief Executive of the institution, the auditor is in a position to determine the nature, extent and timing of the analytical reviews to be carried out in respect of each area of the operations of the institution. For instance, he may decide to carry out limited review in respect of students’ fees if he is of the opinion that the controls in this area are effective. In respect of cheque payments or payments generally, he may decide to carry out detailed reviews if, in his opinion, the related controls are weak.

### **Detailed Examination of the Financial Statements**

The detailed examination of the financial statements of a University will involve: comparisons, reviews, investigations, confirmations, and verifications.

- **Comparisons:** The auditor examines the financial statements of the institution for two successive periods with a view to comparing specific items in one period with corresponding

balances in the previous period, the objective being to obtain satisfactory explanation for any variations.

For instance, the difference between the staff salary of one year with that of the previous year should be justified by either higher figures as a result of promotions or increases in the number of staff, arising from more recruitment.

- **Reviews:** The auditor reviews the figures appearing in the financial statements for consistency with available non-financial data. For instance vehicle running cost must be justified by the number of vehicles being operated and the kilometre log of individual vehicles. Cost of meals at the cafeteria must be justified by the number of students that were served meals during the period.
- **Investigations:** Wherever the auditor is put upon enquiry, i.e. he has reason to be suspicious as a result of the review and comparisons he had carried out, he should investigate the matter to the roots. This will involve vouching, which is an exhaustive examination of a transaction with a view to ascertaining its true meaning and origin.  
For instance, if the auditor suspects malpractice in the purchase of a motor vehicle for the University, he may wish to obtain copies of the relevant vouchers relating to the purchase, the minutes of any resolution to buy, review the various tenders obtained for the supply of the vehicle, and the deliberations of the tenders board where applicable. He may also wish to compare with the price list displayed by major distributors or compare the price with that of similar organisations.
- **Confirmations:** In order to lend weight to the information, which the auditor has obtained from the officials of the University, he may wish to confirm by contracting external sources. For instance, in respect of insurance claims or premium payments, the auditor may contact the insurance company. In respect of bank balances or cheque payments, the auditor may contact the banker. In respect of subventions, he may wish to confirm direct from the national Universities Commission.
- **Verifications:** Generally, the auditor carries out a verification of the items appearing in the financial statements. The verification procedure is designed to ascertain the existence, ownership and valuation of these items.

By so doing, he is reasonable assured of the completeness, validity and accuracy of these items and hence that the financial statements show a true and fair view. For instance, in respect of students fees, the verification work which the auditor carries out helps him to satisfy himself that the amount stated as fees:

- Are indeed in respect of fees and not the proceeds of sale of books or cafeteria meal coupons;
- Are indeed in respect of fees for the year under review and not in respect of fees for a prior year or fees paid in advance; and
- That the amount is correct, without any duplications or omissions.

In respect of subventions, the auditor is able to obtain credible and sufficient evidence that it is not income from the investment of an endowment established by a philanthropic organisation or individual, or the proceeds of a professorial chair established by a professional body or individual.

In respect of cost of furniture purchased, the auditor should be able to confirm that this is not reported as expenditure on repairs and maintenance. In respect of staff salary, he should be able to obtain relevant evidence that no ghost workers were included on the payroll and that the amount paid to each worker is in agreement with his approved rate pay.

On the same basis, the auditor carries out a verification of all other items in the financial statements and is therefore, in a position to either criticise them or confirm their truth and fairness.

### **Specific Audit Difficulties Relating to Financial Institutions**

The financial services industry, comprising various types of financial institutions, plays a significant role in the economic development of the nation. The industry is a sub-sector of the Nigerian Financial System, which includes other players. The Central Bank of Nigeria (CBN) is the apex regulatory authority of the country's financial system while the Nigeria Deposit Insurance Corporation (NDIC) serves as another regulatory institution operating alongside the CBN.

The CBN was established in 1959 under the CBN Act of 1958 and now operates under the CBN Act No. 24 of 1991 (as amended in 1997). It regulates the operations of banks and non-bank (or other) financial institutions.

While the banking sector consists of the commercial banks, the development banks and micro-finance banks; the non-bank financial institutions consist of the finance companies, insurance companies, bureau de change, pension fund administrators, primary mortgage institutions, the Nigerian Stock Exchange, the stock brokerage firms registers and discount houses.

The promulgation of the CBN Act and the Banks and Other Financial Institutions Act (BOFIA), both in 1991, gave the CBN more authority in regulating and supervising the banks and other financial institutions in the sector. In fact, development banks and other financial institutions were placed under the CBN's supervision by virtue of the amendment to the CBN Act in 1997.

### **Banks**

CBN is charged with the responsibility of administering the BOFIA, as amended, which aims at ensuring high standards of banking practice and sustaining financial stability. There are various provisions in both the CBN Act (as amended) and BOFIA (as amended) which govern the operations of banking business in Nigeria. The provisions cover such issues as:

- (a) Minimum paid-up share capital requirements
- (b) Minimum capital ratio
- (c) Minimum holding of cash reserves, specified liquid assets special deposits and stabilization securities
- (d) Returns to be submitted to the CBN by banks, on regular basis (for example, mid-month returns, monthly returns, quarterly returns and semi-annual returns)
- (e) Power of the CBN to conduct routine and special examinations
- (f) Management of ailing banks; and
- (g) Power of the CBN to revoke or vary a bank's license.

In the course of executing its core mandate, the CBN regularly (usually on an annual basis) review the developments in the economy in the preceding years and sets objectives, and targets for the current year. Objectives of monetary policy are contained in the CBN's Monetary Policy Circular. The major objectives of monetary policy are as follows:

- (a) Maintenance of price and exchange rate stability
- (b) Ensuring banking soundness and financial sector stability
- (c) Ensuring effective enforcement of the market rules.

The Prudential Guidelines for Licensed Banks, which were issued by the CBN in November 1990 and updated in May 1991 and July 2001, is still operational and continuously reproduced as Appendix 1 to each edition of the Monetary Policy Circular.

The issuance of the Prudential Guidelines is intended to sanitise the financial reporting system in the banking industry; as its provisions deal primarily with early recognition of losses and adequate provision for bad and doubtful debts in respect of bank lending. The Prudential

Guidelines, coupled with the SAS No. 10 on “Accounting by Banks and Non-Banks Financial Institutions (Part 1)” issued by the Nigerian Accounting Standards Board (NASB) in October 1990, have made banks to desist from their previous “window dressing” or “creative accounting” tendencies. This has been achieved through the four main areas of concern relating to accounting practices and accounting methods that are to be followed by banks and these areas are:

- (a) Income recognition
- (b) Loss recognition
- (c) Balance sheet classifications; and
- (d) Disclosure requirements.

### **Income Recognition**

As regards income recognition, the standard recognises the various sources from which banks earn their revenue and provides a guide for recognising income from each of the sources. These sources include: interest income on loan, overdraft and other risk assets; credit-related fee income; non-credit-related income; lease rental income; and profits arising on sale of loans or discounts with recourse to the seller.

### **Loss Recognition**

In the case of loss recognition, the standard sets out rules to follow in order to achieve a uniform approach towards the recognition of various types of losses. Each bank is required to classify its loans. A loan is classified as “non-performing” if interest or principal is due and unpaid for 90 days or more. Non-performing loans are further classified into sub-standard, doubtful or lost. A non-performing credit facility is classified thus:

| <b>S/N</b> | <b>No. of Days Principal and/or Interests are Unpaid</b> | <b>Classification</b> |
|------------|--|-----------------------|
| 1          | More than 90 days but less than 180 days                 | Sub-standard          |
| 2          | At least 180 days but less than 360 days                 | Doubtful              |
| 3          | 360 days or more   | Lost                  |

The specific provisions for loss on the non-performing loans vary according to the classification of such facility as shown below:

- (a) Sub-standard credit facilities - 10% of the outstanding balance
- (b) Doubtful credit facilities - 50% of the outstanding balance.
- (c) Lost credit facilities - 100% of the outstanding balance.

In addition to the specific provisions stated above, banks are required to make general loan loss provisions of at least 1% of risk assets not specifically provided for. This is to ensure that provision is made against the as-yet-unidentified losses which are known to exist in any portfolio. The section of the standard on balance sheet classifications is aimed at ensuring that certain methods of presenting the balance sheets of banks (which could be described as “window dressing”) are no longer used. These methods usually result in reducing the banks’ reported credit, or reducing their reported deposit, or improving their reported liquidity; thus giving them a bloated financial position. For instance, the net investments in finance leases granted to customers should not be shown as fixed assets on the balance sheet; rather banks should record them as “advances under finance leases”. In the same vein, all transactions should be reported as having been completed unless the expense and delay associated with the analysis and proper classification of such items are out of proportion to the materiality of the reported balance.

### **Disclosure Requirements**

The standard sets out a number of items which banks should disclose in their financial statements. These include items in the statement of accounting Policies, income statement, balance sheet, and notes to the accounts. These are highlighted below:

- (a) The statement of accounting policies should include a brief description of the systematic methods by which non-performing loans are identified and the method by which the provisions for loan losses are determined. Also to be included is the nature of off-balance sheet engagements and the methods used to recognise income thereon.
- (b) In the income statement, each principal revenue item should be stated separately in a bank’s financial statements to enable the users assess the contribution of that particular source. A bank should not offset one item of revenue or expense by deducting from it another item of revenue or expense. The standard states the minimum disclosure requirements for the income statement indicating that the following should be specifically disclosed.
  - i. Interest income split between bank and non-bank sources;
  - ii. Interest expense split between bank and non-bank sources; and
  - iii. Credit-related fee income and expenses where such fees were recognised at once, as against being deferred and amortised.

- (c) As regard the balance sheet, each bank should group its assets and liabilities in the balance sheet according to their nature and list them in the order of their liquidity and maturity. The amount of provision for loan losses, shown separately between principal and interest, should be disclosed and deducted from the relevant asset category. Furthermore, one item of asset or liability should not be off-set by deducting another asset or liability unless a legal right of set-off exists, while the nature and amount of contingencies and commitments arising from the bank's balance sheet engagements should also be disclosed.
- (d) In the notes on the accounts, the bank should disclose the major items that make up its "other assets" and "other liabilities". If there is any other disclosure requirement of the income statement and balance sheet that is not stated on each of these two components of the financial statements, they should be disclosed in the notes on the accounts.

For instance, a maturity profile of a bank's risk assets and deposit liabilities should be provided under the following categories:

|                | <del>N</del> |
|----------------|--------------|
| Under 1 month  | x            |
| 1 – 3 months   | x            |
| 3 – 6 months   | x            |
| 6 – 12 months  | x            |
| Over 12 months | x            |

SAS No. 10 requirements also accord substantially with the requirements of International Accounting Standard (IAS) No. 30, which is "Disclosures in the Financial Statements of Banks and Similar Financial Institutions", issued by the International Accounting Standards Board (IASB) in August 1990. IAS No. 30 became operational for the financial statements of banks covering periods beginning on or after 1<sup>st</sup> January, 1991.

The recent wave of banking reform by the CBN, which started in June 2004, had centred on a thirteen point agenda. Two essential aspects of the reform are:

- (a) Raising of the minimum capital base to 25.0 billion by the end of 2005; and
- (b) Movement of the deposits of key government parastatals (for example, NNPC, NITEL, PHCN) and overhead of core ministries from commercial banks to the CBN, depending on the liquidity conditions of the organisation.

The emergence of universal banking with effect from year 2000 is also worthy of reference here. All these developments have really led to a lot of expansion in the responsibilities bestowed on the CBN over time. There is now a separate department in the CBN for other financial institutions referred to as Other Financial Institutions Department (OFID).

### **Establishment of Nigeria Deposit Insurance Corporation (NDIC)**

The NDIC was also established under the NDIC Act No. 22 of 1988 and became operational in January 1989. It was established against the backdrop of bank failures and the attendant suffering by depositors in the early 1950's as well as the expected deregulation of the banking system in the late 1980's, following the implementation of the Structural Adjustment Programme (SAP).

The establishment of the Corporation was also informed by the approach which was adopted by some other countries to ensure banking stability; for example, the experience of (the then) Czechoslovakia and the United States of America being particularly relevant, the former being the first country to establish a nation-wide deposit insurance scheme in 1924 as a measure to revitalize the country's banking system after the ravages of the first world war, while the latter having established the Federal Deposit Insurance Corporation (FDIC) in 1933 in response to a banking collapse and panic.

All existing licensed banks are required to insure their total deposit liabilities with the NDIC and to contribute a premium, which is equal to 15/16 of 1% per annum of their total assessable deposit liabilities standing in their books as at 31 December of the preceding year. This is with a view to being in a position to provide financial guarantee to depositors in case of bank failure. The NDIC also ensures that banks comply with regulations and practices which foster safety and soundness in the financial market. This is achieved by the constant on-site examination of insured banks and off-site surveillance over all insured banks.

In addition to the above, there are various Sections of BOFIA covering the books of accounts and appointment of auditors. These are as follows:

- (a) Section 24 provides that every bank shall keep proper books of accounts in respect of all the bank's transactions. Where the CBN is not satisfy with the books of accounts kept by any bank, the CBN may appoint a firm of Chartered Accountants to prepare proper books of accounts or render accurate returns for that bank at the bank's expense.

- (b) Section 25 provides for various returns which every bank should render to the CBN on regular basis. This is constantly reviewed through the Monetary Policy Circular.
- (c) Section 26 provides for CBN to regard all statements and returns by banks as confidential but that CBN could publish consolidated statements submitted to it by the various banks (such as contained in CBN Annual Reports).
- (d) Section 27 provides that subject to the approval in writing of the CBN, a bank shall not later than 4 months after the end of its financial year publish, exhibit in a conspicuous position in each of its offices and branches in Nigeria, and forward to the CBN copies of the bank's balance sheet and profit and loss account duly signed and containing the full and correct names of the directors of the bank. Every such published account shall disclose, in detail, penalties paid as a result of contravention of the provisions of BOFIA and the auditor's report shall reflect such contravention.
- (e) Section 28 provides that every balance sheet and every profit and loss account of a bank shall give a true and fair view of the state of affairs of the bank as at the end of the reporting period; and those forwarded to the CBN shall comply with the requirements of any circular which has been issued by CBN.
- (f) Section 29 provides for the appointment of a qualified person as "the approved auditor" of a bank, such appointment being approved by the CBN. Whenever the approved auditor in the course of his duties as an auditor of a bank, is satisfied that:
  - i. there has been a contravention of BOFIA, or that an offence under any other law has been committed by the bank or any other person; or
  - ii. losses have been incurred by the bank which substantially reduce its capital funds; or
  - iii. any irregularity which jeopardises the interest of depositors or creditors of the bank, or any other irregularity has incurred; or
  - iv. he is unable to confirm that the claims of depositors or creditors are covered by the assets of the bank; he shall immediately report the matter to the CBN.

The approved auditor shall forward to the CBN two copies of the domestic reports on the bank's activities not later than 3 months after the end of the bank's financial year.

The above issues are not exhaustive about the special characteristics of auditing of banks. There are usually changes to or reviews of both the statutory and regulatory matters concerning banks. Consequently,

auditing of a bank calls for a clear understanding of all the above issues and more importantly there is a need for the audit files (both permanent and current) to be updated from time to time in order to be ahead of developments, not only in respect of the particular bank being audited but also in respect of the entire industry.

### **Some Guidelines on the Audit of Banks**

- (a) The auditor should review carefully all the loans and advances of the bank during the period of the audit with a view to ascertaining the correct application of the provisions of the Prudential Guidelines as well as SAS No. 10 with regard to the gross interest earnings. This review will also confirm the correctness of the provision for bad and doubtful accounts
- (b) The other sources of revenue should also be carefully investigated so as to obtain evidence for their inclusion in the accounts. Some of these revenue items are: fees and commissions, lease income, dividend from investments, and foreign exchange earnings
- (c) Interest expenses should be verified for both correctness and completeness
- (d) Apart from loans and advances, the auditor should pay particular attention in each of the other peculiar items of a bank's balance sheet.  
Examples of these are: short-term funds, bills discounted, equipment on lease, other assets (including inter-branch balances and a myriad of items), deposit and current accounts, other liabilities (including provision for frauds and losses), statutory reserve, reserve for small and medium scale industries, contingent liabilities and other obligations on behalf of customers and customer's liability thereof:
- (e) The auditor should comply with all the provisions of the Prudential Guidelines and SAS No. 10 with regard to income recognition, loss recognition, classification of balance sheet items, and the disclosure requirements; and
- (f) The auditor should comply with all the provisions of BOFIA regarding the audit of a bank, including the submission of two copies of the domestic report on the bank's activities to the Central Bank of Nigeria within the stipulated time.

### **Challenges of Information Technology on the Audit of Banks**

The auditor should pay particular attention to the challenges that information technology has brought into the audit of banks and therefore appreciate the need for an effective and efficient internal control system.

**These challenges include the following:**

- (a) Probable incidence of computer fraud
- (b) Possible problems that may be associated with real time on line operations
- (c) Possibility of input errors (Garbage in garbage out- GIGO);
- (d) Possibility of system errors; and
- (e) Problems that may be associated with the application of computer based audit procedures,

**Insurance Companies**

Insurance companies, being limited liability companies, are concurrently governed by CAMA and the Insurance act of 2003. The National Insurance Commission is the supervisory body for the industry. There are two classes of insurance business: life insurance business called Life Assurance Companies and General Insurance business. Life assurance business is an insurance business under which, in consideration for premiums paid, the company undertakes to pay an agreed benefit, primarily on the survival of the policy holder to a specified age or on death whichever occurs first.

Life assurance business includes whole life, endowment, annuity, pensions, permanent disability, and capital redemption or pension fund management business. Life assurance business is generally referred to as long term business. This is classified into personal or group life assurance. Personal relates to a policy that covers only one person, while group will cover a group of people like the employees of a company.

**(a) Special Requirements for Insurance Business**

Except for mutual assurance or insurance set up under a cooperative society arrangement, only companies registered under the Companies and Allied Matters Act may carry on insurance business in Nigeria. Hence all insurance companies are limited liability companies. The share capital requirements with effect from March 2007 are as follows:

- Life assurance companies - N150 million
- General insurance business - N200 million
- Composite insurance - N350 million
- Reinsurance business - N350 million

**The Statutory Deposit Requirement is as follows:**

- 50% of paid-up capital for intending companies, and
- 10% of paid capital for existing companies.

This is to be deposited with the CBN and attracts interest at the minimum lending rate. It can only be withdrawn in line with provisions set out in section 10 of the Act.

**(b) Accounting and Auditing Requirements**

Insurance companies (including life assurance companies) are required to prepare separate revenue accounts for each class of business undertaken in addition to a profit and loss account. Insurance business is a specialised type of business requiring that the auditor's working papers should be compiled such that all aspects of the business will be covered in order to ensure a thorough audit work.

The peculiar aspects of the accounts, and hence the audit of an insurance company, are in respect of the following:

**(c) Unexpired Risks**

At any balance sheet date, some of the premium already received will normally include that for the periods subsequent to the balance sheet date. There are therefore the tendencies of the covered risk attracting full liability on a future date. The insurance company, in addition to carrying forward the premium which relate to periods beyond the balance sheet date as "unearned premium", makes provision for amounts required to meet the full claims and expenses on the businesses still in force after the accounting period.

The assessment of an unexpired risk and the provision thereon is a highly specialised exercise. Unexpired risk is like an uncompleted contract whose outcome cannot be determined with any certainty. It is not the duty of the auditor to determine for a company the method of assessing or making provision for unexpired risks. This is the duty of management and it is usually based on experience and the special circumstances of each case. It is for the auditor to assess the adequacy and reasonableness of the particular method adopted. He should ensure that this appears reasonable and in line with the method generally adopted in similar businesses. It is also important to ensure that the method is consistently applied from year to year. Where there is a change in the method, this must be disclosed together with the effects on the financial statements of such a change.

Unexpired risks are like post balance sheet events, it is however necessary to point out the difference in the method of treatment in the accounts. Where the covered event occurs subsequent to the balance sheet date, it does not necessitate any adjustment in the financial statements as it does not relate to the current year but to a subsequent

year. Where however the effect of such an event is material, it may be necessary only to disclose the occurrence.

**(d) Claims**

Unexpired risks are associated with non-life businesses and claims may occur both in respect of life and non-life business. Claim is the amount payable under a contract of insurance on the occurrence of the insured event. Claims handling expenses are costs incurred in the process of investigating or settling claim, they are regarded as direct expenses. Where these expenses cannot be attributable to a particular claim, they are regarded as indirect expenses.

It is essential for the auditor to ensure that in determining the amount of claims that all claims handling expenses have been included. This is to ensure that each revenue account gets the charge for all expenses related to the claims incurred. There should also be a good basis of apportioning indirect claims handling expenses. Alternatively, this may be a charge in the profit and loss where a reasonable basis cannot be determined. Proper cut-off should also be observed in dealing with claims handling expenses in order to ensure that these are charged in the same period with the related claims.

**(e) Investment Expenses**

Investment expenses are those expenses arising from the buying, holding or selling of investments, excluding such costs relating to stamp duty and brokerage on the acquisition and disposal of investments. Investment expenses are associated more with life assurance business as income from investment constitutes the most important revenue of a life business. Investment expenses are principally those costs incurred as a result of holding and managing investments such as the salaries of the investment manager or investment analyst or the cost of safe custody for investment certificates.

The cost of buying or selling investments will include the cost of obtaining information, printing and stationery or the cost of courier and postage to the extent that they are not incurred and billed by the stockbroker. As with claims, it is the duty of the auditor to ensure that investment expenses are matched with the related income from investment and in the correct period.

**(f) Underwriting Expenses**

These are costs incurred in assessing insurance contracts and other related expenses incurred in servicing existing contracts after the acquisition, renewal or amending existing contracts. The treatment given to underwriting expenses will depend on the basis of accounting adopted by the insurance company. Where the annual basis of accounting is adopted, the underwriting results and hence the underwriting expenses are recognised during the accounting year. The result will therefore include adjustments made to estimates used to determine the underwriting result of the preceding year. Where the deferred annual basis of accounting is adopted, the result of the underwriting business cannot be determined in the current year and is hence carried forward to a future period together with the related underwriting expenses.

**(g) Statutory Deposits**

Statutory deposits which an insurance company is required to maintain with the Central Bank at all times. This deposit is an asset to the insurance company as it earns interests to the insurance company at the minimum lending rate stipulated by the Central Bank. This deposit is not available for use by the insurance company except in limited circumstances as may be approved by the National Insurance Commission.

**(h) Reserve Requirements**

An insurance company is required to maintain the following reserves:

In respect of its general business:

- i. Provision for unexpired risks, calculated on a time apportionment basis of the risks accepted during the year
- ii. Provision for outstanding claims which shall be equal to the total amount of such outstanding claims and a further sum equal to 10% of outstanding claims to cover claims not yet reported at the end of the year; and
- iii. Provision for outstanding claims.

Note that (b) above represents those claims that have been reported but not yet accepted while (c) represents those claims that have been reported and accepted.

Contingency reserve required of a general business is an amount not less than 3% of total premium or 20% of net profit whichever is greater. This is accumulated until it attains an amount equal to 50% of net premium or the minimum paid-up share capital whichever is greater.

For life business, there shall be maintained:

- i. A general reserve which shall be equal to the net liabilities on policies in force at the time of actuarial valuation and an additional amount equal to 25% of net premium for every year between actuarial valuation dates; and
- ii. A contingency reserve equal to 1% of gross premium or 10% of profit whichever is greater and which is accumulated until it attains the amount of the minimum paid-up capital.

In addition, an insurer in respect of its general business shall maintain a margin of solvency which shall not be less than 15% of the gross premium received less reinsurance premium received less reinsurance premium paid or 15% of the paid-up capital whichever is higher.

**(i) Insurance Funds**

All receipts relating to each class of business are credited to a separate account and built into a separate fund

For a life business, there should be a further separation of the fund into:

- Individual life fund
- Group life fund; and
- Health insurance fund.

Funds for each class shall at all-time represent the liabilities in respect of that class of insurance and shall consist of:

- in the case of life insurance, the fund shall be an amount not less than the mathematical reserve, and
- in the case of a general business, the fund shall be the total of the provisions for unexpired risks, outstanding claims and expenses of settlement of such claims.

**(j) Outstanding Claims**

As at the balance sheet date, there may be in respect of policies in force, risks covered which have occurred but which have not yet been settled by the insurance company. These are prescribed as outstanding claims in the financial statements of the insurance company. The provision made for outstanding claims will depend on the circumstances.

There may be:

- claims notified and agreed
- claims notified but not agreed; and
- claims incurred but not notified.

The provision made for claims notified and agreed is the amount of the claims plus the estimated amount of the claims handling expenses. For claims notified but not agreed the provision shall be best estimate by the management plus an estimated amount of claims handling expenses. The estimate of the claims shall not however be in excess of the amount claimed by the insured.

In respect of claims incurred but not reported, the provision shall be based on the experience of the management relating to such business. It shall however not be lower than 3% of total premiums in the class of business or 20% of net profit whichever is greater. It is the duty of the auditor to search minutes, correspondence and records of periods subsequent to the balance sheet date in order to ensure that those claims that relate to the period under review have been taken up. For all claims generally, it will be the duty of the auditor to satisfy him or herself that a consistent and apparently reasonable and acceptable method has been adopted in making provisions for outstanding claims.

Where there has been a change in the method, it will be necessary to disclose this fact together with any material effects on the financial statements.

### **(k) Determination of Life Insurance Profit**

The profit of a life business is determined only by actuarial valuation of the liabilities and comparing this with the available assets. The valuation should be made whenever it is decided to distribute bonuses (dividends) but at least once in every three years.

The method of actuarial valuation is as follows:

- i. Determine the present value of the company's total liabilities on all the current policies in force in respect of:
  - sums assured, and
  - bonuses already declared.
- ii. Determine the present value of the total premiums receivable by the company under the existing policies less expenses.

- iii. Deduct (ii) from (i) above to determine the company's net liability on all policies.
- iv. Deduct (iii) above (net liability) from the total life fund as per the last balance sheet. The difference if positive is the surplus on the life fund to be transferred (credited) to the profit and loss account. If negative, it is a deficiency to be transferred (debited) to the profit and loss account.

### **Verification of the Assets and Liabilities of Insurance Companies**

The steps an auditor should take in the verification of the assets and liabilities of an insurance company are as follows:

- i. The internal control and check system should be examined in depth in order to assess its adequacy in accounting for the revenue, expenditure, assets and liabilities; and
- ii. Premium income should be checked with new policy books, renewal register and lapsed policies. For non-life business, premium income is part of revenue, but there must be proper cut-off to ensure that only premiums relating to the period are taken up on an actuarial basis.

### **Hence, the Auditor should ensure that:**

- i. Unpaid premium is included both as premium income and debtors
- ii. Premium received in advance is excluded from revenue and included as creditors
- iii. Commissions paid should be checked with agents' returns, note books and accounts. Such commissions must be in line with the company policy
- iv. Surrendered policies are checked with endorsed policies to ensure their removal from the policy register
- v. Claims paid are checked to the claims register and related correspondence
- vi. Re-insurance premiums and claims on reinsurance are checked with contracts entered into
- vii. Where separate funds are maintained, the funds should be seen to have been applied for the specific purpose for which they were set aside; and
- viii. The actuarial valuation of life policies currently in force should be checked by the auditor in order to ensure the appropriateness and consistency of the valuation.

This is the basis for determining the surplus (or deficit) on the life to be transferred to or from the profit and loss account at the end of the year.

The auditor should enquire into the qualification and reputation of the value. The valuation is carried out at least once in three years. The auditor should report any inconsistency and the effects on the financial statements.

### **Primary Mortgage Institutions (PMIs)**

These are organisations engaged in originating, marketing and serving real estate mortgage loans either as principals or agents. They are classified along with other organisations (such as finance houses, discount houses, Bureau De Change) as other financial institutions and therefore covered by the provisions of Sections 56-59 of BOFIA.

Section 59 of BOFIA states clearly that the CBN shall have power to supervise and regulate the activities of other financial institutions, so these institutions are also subject to the supervision and examination by the CBN.

### **Primary Mortgage Institutions usually engage in four main activities, namely:**

- (a) Mobilisation of savings
- (b) Lending of funds for the acquisition of real estate
- (c) Servicing of mortgage loans; and
- (d) Purchase and sale of mortgage loans, together with Secondary Mortgage Institutions (SMIs). SMIs are operators dealing in mortgage instruments arising from transactions in the primary mortgage market. Both PMIs and SMIs deal in commercial papers, treasury bills, bankers' acceptance, etc.

SAS No. 15 provides guidelines for accounting for Non-Bank Financial Institutions (NBFIs), among which are PMIs.

The standard focuses on the following three main areas:

- (a) Income recognition
- (b) Loss recognition; and
- (c) Classification and disclosure in financial statements.

### **Income Recognition**

In respect of income recognition, SAS No 15 specifies that PMIs should report each significant item of revenue separately to enable the user of its financial statements to assess the contribution of that particular source of revenue. These significant items of revenue include: interest on loans; credit-related fee income; non-credit related fee income; all of which should be recognised as and when earned. In the case of any

transaction where success is doubtful and income contingent on completion, PMIs should not recognise the income associated with such a transaction until it is reasonably certain that the transaction will be completed.

### **Loss Recognition**

Concerning loss recognition, SAS No. 15 takes into consideration the various types of transactions which PMIs could be legitimately involved in and states how losses related to such transactions can be accounted for. Some of them are as stated below:

- (a) In the first place just as in the case of banks, PMIs that have loan portfolios should analyse and classify them between performing and non-performing facilities.
- (b) Secondly, after making a thorough and systematic review of all its credit risks, including loans, leases and off-balance sheet engagement, each PMI should estimate and make general and specific provisions against loan losses. The provisions should take due account of the long-term nature of the loans and the security available. If a repayment becomes overdue for three months, no further income should be recognised until regular payments resume. Provision against principal should be considered if repayment becomes overdue for more than six months. Where principal repayment is overdue by more than one year, the outstanding un-provided portion should not exceed 50% of the estimated net realisable value of the security. Where principal repayment is overdue by more than two years, there should be no outstanding un-provided portion of the credit facility, irrespective of the estimated net realisable value of security held.
- (c) Thirdly, short-term investments should be carried at the lower of cost and net realisable value, with disclosure of market or directors' valuation.  
The exception is the case of a net cumulative loss having been incurred when the sad net loss should be charged to the income statement in the period it first arises and any subsequent net gains are credited to the income statement to the extent that the losses have been previously charged.
- (d) Fourthly, long-term investments should be carried at cost, with disclosure of market or directors' valuation, unless a permanent diminution in value occurs, when the carrying amount of the asset in the books of the PMI should be reduced to recognise the loss. (SAS No. 13 – Accounting for Investments provides for how to determine such a permanent diminution).

- (e) Other areas of loss recognition covered include sale of loan or securities with or without recourse, foreign exchange transactions (which should be treated in accordance with SAS No. 7) and forward contracts.

### **Classification and Disclosure Requirements**

In addition to the disclosure requirements of SAS No. 2 (Information to be disclosed in financial statements), SAS No. 15 states that PMIs should also disclose the following:

- (a) The methods and bases by which provisions for loan or securities losses are made
- (b) The nature of off-balance sheet engagements and the methods used to recognise income or loss thereon
- (c) Total liabilities to National Housing Fund
- (d) Total value of Mortgage Assets and movements thereon, showing assets brought forward, additions during the year, disposal and realisation during the year, and balance carried forward
- (e) Other sources of funds apart from share capital and National Housing Fund
- (f) Classification of mortgage loans receivable and mortgage backed securities into those held for sale and those held for long term investment; and
- (g) Detailed breakdown of servicing rights acquired during the year stating the amount capitalised, the method of amortisation, and the amount amortised.

All the above in addition to all the relevant provisions of CAMA and BOFIA as they relate to primary mortgage institutions are the areas which an auditor will need to consider in approaching the audit of PMIs.

### **SELF-ASSESSMENT EXERCISE**

What are the features of audit relating to hospitals and hotels?

### **3.3 Audit of Not-for-Profit Organisations**

Not-for-profit organisations are those entities that posse the following characteristics which distinguish them from business enterprises:

- (a) Contributions of significant amounts of resources from resources providers who do not expect commensurate or proportionate pecuniary returns
- (b) Operating purposes other than to provide goods or services at a profit; and

- (c) Absence of ownership interests like those of business enterprises.

These not-for-profit organisations include educational, social, scientific, literary cultural, religious, sporting, charitable, voluntary, health and welfare entities set up in different forms and sizes. They receive significant amounts of resources from members of the public, government and organisations that identify with their mission. For instance, large corporations in the private sector willingly donate to some of these not-for-profit organisations from year to year, as shown in the annual reports and accounts under corporate social responsibility.

The two examples of charities and NGOs given in the syllabus are merely to indicate the types of not-first-profit organisations. Some of them are so big and complex because of their set up while others are very small in their scale of operations.

It is noteworthy that Section 673 of CAMA provides for incorporation of trustee of certain bodies and associations (under Part C of CAMA). It is, however, optional for the trustees of any association of persons established for any religious, educational, literary, scientific, social, cultural, sporting or charitable purpose to apply for registration under CAMA. It is based on whether the association opts for registration or not. Once the association has opted for the registration of its trustees, such trustees, such trustees shall become a corporate body in accordance with the provisions of Section 679 of CAMA. The procedure for and effect of registration are stated in Section 674 – 679 of CAMA. Some not-for-profit organisations have their own enabling Act while some others are incorporated as companies limited by guarantee.

The audited approach to be adopted for-not-profit organisations requires some duty of care from the auditors. Each organisation should be considered properly in order to identify first and foremost the structure of the organisation. For example, is it a company, an incorporated trustee or an association with only a constitution or rules and regulations?

Whatever the structure of form, the auditor is required to understand it in detail with particular reference to any applicable accounting and auditing standards principles and guidelines.

**Other matters which the auditor should consider carefully are:**

- (a) The letter of engagement setting out the terms of the engagement who the auditor should report to
- (b) All the sources of fund should be carefully investigated so as to obtain evidence for their inclusion in the accounts. Some of the

funds may be in the form of grants, some of which are meant for specific events which when they do not take place will translate to a refund of the amount to the donor(s). the auditor should take note of this and consider making a provision for it or at least disclosing it by way of a note

- (c) Cash collections can be verified for completeness with some commitment on the part of the auditor. An internal control system of recording cash collections can be instituted to aid verifications in future
- (d) Expenditure can be verified by reference to written evidence and process of authorisation
- (e) Fixed assets should be verified in the usual way, though the donated portions thereof should be valued in some appropriate way in order to recognise and account for the asset
- (f) Some of the funds come through direct donations, endowments or legacies. The instruments setting up each of these should be checked and the movement in the accounts of each of these items should be checked annually; and
- (g) Finally, the auditor should always prepare a report to be submitted to the person(s) indicated in the letter of engagement.

### **Charities**

Charities are not for profit organisations usually set up by philanthropic individuals or organisations to engage in welfare activities. Usually, there are no strict legal rules governing charities except to the extent that they may not engage in any illegal, anti-social or subversive activities. For convenience and in order to assume a definite legal structure, some charities may be incorporated as companies limited by guarantee. Some problems are usually associated with charities as a result of the nature of the activities, sources of income or staff engaged.

These are:

- (a) The staffs engaged in charities are usually not trained in accounting, business or finance. Little emphasis is placed on the system of internal control as greater emphasis is placed on the integrity of the staff (volunteers)
- (b) The sources of revenue to a charity are diverse and indefinite, hence there is the problem of determining the completeness of receipts
- (c) The expenses of a charity are of non-business nature and usually involve third parties who may not undertake any form of documentation. For instance, refugees may not issue any receipts for resettlement cash paid to them

- (d) Benefit-in-kind received from donors may not be appropriately valued as a basis for proper accounting measurement; and
- (e) The activities of charities may be so diverse and unrelated such that there can be no consistent method of recognising income or accruing for expenses.

Most charities have overseas affiliates, hence it may be required that their accounts will be delivered to the overseas sponsors for incorporation into the accounts of the affiliates. It is therefore essential for the auditor to ensure that the financial statements of the local charity meet the requirements of the overseas sponsors.

### **The Audit Approach**

The following approach may be adopted by the auditor with respect to most charities:

- (a) Obtain a copy of the constitution of the charity for his understanding and the permanent file. He should ascertain the requirements for accounting and audit
- (b) Send a letter of engagement in order to specify the objects of the engagement and the nature of his report
- (c) Verify the funding of the charity in order to ensure that all funds have been received. If funds are repayable, it should not be treated as revenue but a liability which should be appropriately disclosed in the account
- (d) Most charities receive legacies arising from wills. Copies of relevant wills should be obtained and studied by the auditor in order to ensure that all legacies have been received in full as devised by the deceased especially in cases of reversions
- (e) Donations should be verified by ensuring that so far as possible, cheques are drawn crossed restrictively in the name of the charity and by sending acknowledgements
- (f) Cash collections should be counted as soon as possible in the presence of two persons. Such cash should be recorded and acknowledged by two persons. Such cash should be recorded and acknowledged by the volunteer responsible for the custody. Where collections are made in collecting boxes or tins, these can only be opened and counted in the presence of two persons;
- (g) Expenditure can be verified by reference to the appropriate vouchers which must be duly authorised
- (h) Outstanding expenditure should be verified at the end of the year to ensure that all liabilities have been included
- (i) Fixed assets should be verified as to existence, ownership, and valuation. Appropriate values should be attached to all gifts in kind

- (j) The auditor should assess the liquidity of the charity with a view to determining whether the going concern concept applies as is appropriate. Where the liquidity problem is so acute, it will be necessary for the auditor to express an opinion as to the uncertainty of the charity continuing as a going concern;
- (k) Where donations are received in kind, the auditor should state the appropriate monetary measurement; and
- (l) The nature of the report the auditor will issue depends on whether the charity is:
- accompany limited by guarantee
  - a trustee established by law; or
  - an unimportant entry.

The underlying objective of the audit of a unit trust may not include an expression of opinion that the financial statements show a true and fair view. Most of these financial statements may comprise of a receipts and payment account, the object of the audit being to obtain an assurance as to the honesty, integrity and competence of the handlers of the affairs of the charity.

### **Pension Funds**

Pensions are amounts paid to a worker at retirement or on attainment of a specified age. This may be paid as lump sum or as an annuity. It is therefore, a recurring liability on the part of any company to pay such pension. For this reason, therefore, companies like to build up funds so as to ensure that such recurring liabilities are met when due without, in any way, affecting the smooth operations of the company.

The Pensions Reform Act of 2004 has relieved employers of the burden of managing pensions and transferred this responsibility to designated Pension Fund Administration (PFAs). Under this arrangement, employers have the responsibility of making appropriate monthly contributions, which together with the mandatory amount deducted from the employees remuneration, are remitted to the employee's nominated PFA. Such remittances are credited to employee's account and accumulated until maturity. The management and remittances from the fund at maturity is based on the agreement between the employee and the PFA.

Under the Pension Reforms Act 2004, it is now mandatory that employers contribute at least 7 ½ % of employees' emolument to the pension fund monthly, while the employee contributes an additional 7 ½ %. The employer may increase ratio of contribution, provided that total contribution is not less than 15% in any case.

Gross emolument of an employee is calculated to be the total of basic, transport and housing allowances due to an employee in any particular month.

### **The Auditor's Duties**

Whichever form the pension takes, the auditor's duties are as follows:

- (a) Examine the agreement existing between employee and employer and ensure that the provisions have been fully carried out.
- (b) Verify that proper control is exercised over the transactions of the fund, such as:
  - i. Deductions from contributors' wages; and
  - ii. The total contributions remitted to the PFA on monthly basis.
- (c) Verify that the pension deduction agree with the provisions of the Pensions Reform Act, 2004.
- (d) It is vital for the auditor to ensure that the realisable assets available to the old pension fund are paid to the employees or transferred to the new PFA on agreement with the employees; and
- (e) It is important on grounds of public interest, for the auditor to determine and state in his management letter if the pension funds is being managed in the best interest of the employees.

### **SELF-ASSESSMENT EXERCISE**

State and describe the items involved in the detailed examination of the financial statements of a university.

### **3.4 Joint Audit**

A joint audit is an audit assignment that is carried out by more than one audit firm at the same time and for the same financial statements. It is at time necessary or advisable to have joint audits where management or shareholder would like to have more than one assurance on the audit of their financial statements. It is also applicable where the operations of the company are somehow very large or complex that it might require the combination of the efforts of more than one firm to have an effective and timely audit. Joint audit is more pronounced in the banking industry where many branches spread all over the country and the auditor has to visit a number of the branches annually.

Also where shareholders perceive that their interests are better served, they might opt for joint audit. An example is where a multinational company operating in Nigeria has an international firm of auditor, the local shareholder or investors might argue for a joint auditor who will be able to take adequate care of their interest, although this is just a perceived rather than a real problem as any auditor should be able to take care of the interest of all parties.

As provided in the Rules of Professional Conduct for members of ICAN, a member whose firm is nominated as a joint auditor should communicate with all existing auditors and be guided by similar principles, to those set out in relation to nomination as an auditor. Where it is proposed that a joint audit appointment becomes a sole appointment, the surviving auditor should communicate formally with the other joint auditor as though it is for a new appointment.

As regards the principles set out for a new appointment, the following are formally with the other joint auditor as though it is for a new appointment.

- (a) When a member is first approached by a prospective client, he should explain that he has a professional duty to communicate with the existing auditor or adviser
- (b) When nominated or asked to act, the member should ask the client to inform the existing auditor of the proposed change and also give the latter written authority to discuss the client's affair with the member
- (c) The member should then write to the existing auditor seeking information, which could influence his decision as to whether or not to accept the appointment
- (d) If the client fails or refuses to grant the existing auditor permission to discuss report that fact to the proposed auditor, the existing auditor should report that fact to the proposed auditor who should not accept nomination/appointment; and
- (e) The existing auditor should answer without delay the communication from the prospective auditor.

The joint auditors are both jointly liable for the assignment they undertake as only a single set of financial statements is signed by both of them at the end of the audit. It does not matter who audits what aspect during the audit.

**The Responsibilities/Liabilities of the Joint Auditors are:**

- (a) Ensure that the term of the assignment is clear as being that of joint audit and not that one firm is doing accounting work and the other an audit
- (b) There should be meeting(s) with the client by the joint auditors where agreements are reached on the approach to the work and the responsibilities for the work at a particular time
- (c) Ensure that all agreements as to work division are in writing and are not ambiguous
- (d) There should be periodic review of progress of work by partners of the two firms
- (e) There should be exchange of working papers by the joint auditors so that each firm has a full set of working papers for the year's audit
- (f) If possible the joint auditors should use the same audit programme to ensure that all aspects of the work are covered;
- (g) In some situations there should be a joint work in respect of certain areas of the client's operations. For example, both joint auditors should review the loans and advances of a bank every year and have a common position on issues like provisions to be made; and
- (h) Financial statements should be jointly reviewed and agreed by the joint auditors before being presented to management.

All the above steps are necessary in order to ensure that clients do not decide to change their auditors simply because of conflict of viewpoints. The clients have the right to choose or change their auditors if they so desire, but this should be carried out in an appropriate manner as specified in CAMA under the appointment of auditors.

**SELF-ASSESSMENT EXERCISE**

What is a joint audit?

**4.0 CONCLUSION**

The auditor of any bank or other financial institution has several duties. Apart from conducting the audit and reporting to management, audit committee, board of directors and the shareholders at the annual general meeting, he has to submit various types of reports to different types of regulators in accordance with the provisions of different statutes as appropriate.

## 5.0 SUMMARY

This unit dwelt on audits of different types of organisation's audit; general approach to audit; specific approach to each organisation's audit; audit of specific industries, such as farmers, professionals, hospitals and hotels; specific audit difficulties relating to financial institutions; audit of not-for-profit organisations and joint audits.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. What is a joint audit?
2. What are the responsibilities of the joint auditors?

## 7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountants of Nigeria.(2004). *Advance Audit and Assurance*. Lagos: ICAN.

Izedonmi, P. F. (2001). *Auditing and Investigations: Questions and Suggested Answers*. Benin City: UNIBEN Press.

Millichamp, A. H. (2002).*Auditing*. London.

Olusanya, F. T. (2001). *Auditing & Investigation: A comprehensive Approach*. Lagos: Negro Ltd.

## **UNIT 5 INVESTIGATION**

### **CONTENTS**

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  - 3.4 The Report Appropriate to Each Type of Investigation
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing investigation, examination of financial forecasts and projections, forensic investigation and audit, and report appropriate to the type of investigation.

### **2.0 OBJECTIVES**

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

- explain the nature, classes and methods of investigation
- outline some of the matters that should be featured in the detailed programme for carrying out the reporting accountant's investigation assignment
- discuss the work programme of a reporting accountant
- describe the main features of the work programme in financial forecast and projections
- explain litigation support and investigative accounting of forensic accounting
- outline a typical approach to a forensic accounting assignment.

### **3.0 MAIN CONTENT**

#### **3.1 Investigations**

This section deals with “Specialised Audit and Investment”. It is aimed at discussing those aspects of the functions of an accountant, which are strictly outside the realms of auditing. These functions are referred to as investigations. When accountants, as auditors are requested to carry out

investigations, they do so in addition to their statutory duties to the shareholders of the company.

### **Distinction between Auditing and Investigations**

As presented in the Preface to Auditing Standards and guidelines issued by the Institute of Chartered Accountants of Nigeria (ICAN), “an audit is the independent examination of an 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 law and regulation”. While it is the responsibility of management of the enterprise (in the case of a company, the directors) to prepare the financial statements of the enterprise and present same to the auditors, it is the responsibility of the auditors to report on the financial statements as presented to them.

The relevant law in the case of the audit of a company is the Companies Allied Matters Act (CAMA), Cap. C20, LFN 2004 and any other enabling Act as appropriate to the organisation involved. For example, Banks and Other Financial Institutions Act (BOFIA), 1991, Central Bank Act, 1991 and Nigeria Deposit Insurance Corporation Act, 1988, as amended for banks and other financial institutions and the Insurance Act, 2003 for insurance companies.

The external auditor of a company is responsible to the shareholders of the company and his scope of work arises from the responsibilities placed on him by the provisions of CAMA. His function, which is required statutorily, is to lend credibility to the financial statements of the company to which he serves as auditor.

In addition to legal requirements, there may also be regulations to comply with, for example, CBN monetary and fiscal policy circulars, National Insurance Commission (NAICOM) guidelines.

The responsibility for the prevention and detection of fraud and irregularities is that of the management of the enterprise who may obtain reasonable assurance that this responsibility has been discharged by establishing an adequate system of internal control. It is not part of an auditor’s duties to search for fraud unless he is required to do so by a specific term of his engagement. However, if properly carried out, the work of an auditor should expose fraud and irregularities where they exist.

Investigations consist of various non-auditing tasks carried out by accountants, who usually have served as auditors to the organisation. Oremade (1988) has defined investigation as “an act of examining,

searching and inquiring into a matter with adequate care and accuracy; usually undertaken to obtain information of particular or special nature". It is not statutorily required of an auditor. In order to avoid being held liable for not performing the assignment well, an auditor conducting an investigation should have his instructions clearly stated and should continuously bear in mind throughout the duration of the assignment, the objectives and purposes set out in the instructions.

An auditor conducting an investigation is seen as an expert and should therefore exercise great skill and care. He should see the assignment as it is, that is, involving an inquiry into the financial affairs of a business with definite purposes and defined objectives, as laid down in the client's instructions. It is also necessary to note that the exact scope of the assignment and the type of report required at the end of the assignment should be agreed by all parties prior to the commencement of the assignment. The work required for a particular type of investigation may be wider or narrower than the function of auditing, depending on what type of investigation that is being conducted.

### **Nature, Classes and Methods of Investigation**

#### **Nature**

Auditors usually have a special type of relationship with the companies to which they serve as auditors. The relationship is that of familiarity with the affairs of the company, which emanates from the experience which their audit function has afforded them the opportunity to have. Consequently, auditors are usually in a very good position to conduct investigations. Again, it is necessary to emphasise that auditors conduct investigations purely as experts or specialists and not as part of their statutory audit function.

#### **Classes**

The various classes of investigations can be derived from the various reasons for which such assignments are carried out. The following are some of the different classes of investigations:

- (a) Investigation for the proposed purchase of a business or for investment purpose
- (b) Investigation for a lending banker or financial institution for audit appraisal purpose
- (c) Investigations under Companies and Allied Matters Act (CAMA), 1990 as amended (Section 589 in respect of investigation of a Unit Trust Scheme)

- (d) Investigation to ascertain the extent of suspected financial crime or fraud, burglary or damage caused by fire
- (e) Investigation for a prospective partner
- (f) Investigation preceding the issue of a prospectus; and
- (g) Investigation for the purpose of business re-organisation and reconstruction or for a merger and acquisition scheme.

### **Methods**

The methods of carrying out investigation assignment can be divided into three major stages with each stage having its separate sections as shown below:

#### Stage 1      Preparation

- (a) The preliminary review
- (b) Obtaining written instructions from clients; and
- (c) Planning.

#### Stage 2      Field work

- (a) Ascertaining the facts and obtaining information from relevant people; and
- (b) Examination and verification of data obtained.

#### Stage 3      Reporting

- (a) Interpretation and evaluation of evidence; and
- (b) Writing the report of the assignment.

The above is a general approach that can be adopted for carrying out any investigation assignment while specific variations to the general approach will depend on the purpose for which the assignment is conducted.

The investigating auditor should appreciate the need to be familiar with the business concerned and understand the client's instructions. Thereafter, he would need to plan his programme in accordance with the client's instructions, which should have been obtained in writing.

Usually, the clients will like the investigating auditor to put in writing his own understanding of the assignment, state the time plan or time schedule that he thinks will fit into the assignment, as required by the client.

The second stage involving field work can take a relatively long time or a short period depending on the extent to which the investigating team may have to go. In some cases, information and data may need to be obtained by visiting some of the branches of the organisation or even with the assistance of other experts. The data obtained most usually will have to be subjected to analysis in order to make them more relevant to the third and final stage, which is that of reporting.

The report of the investigating auditor should include sections on the following matters:

- (a) Executive summary
- (b) Detailed report
- (c) Nature of the assignment;
- (d) Date on which the client gave his written instructions for the assignment
- (e) Scope of the investigation
- (f) The approach used in carrying out the assignment
- (g) Findings and observations; and
- (h) Conclusions and recommendations.

The value of the report could be enhanced by the inclusion of schedules, tables, graphics and charts to properly support and explain the findings.

### **Auditor's Involvement with Prospectuses and other Offer Documents**

There is an auditing guidelines entitled "Prospectus and the Reporting Accountants" issued by ICAN and this guideline has clearly set out the various aspects of what a member of the Institute should do if he is required to act as Reporting Accountant under the provisions of CAMA and/or the Listing Requirements of the Nigerian Stock Exchange (NSE). The content of the guideline is covered extensively in this section of the Unit.

A reporting accountant is a chartered accountant in public practice, who is reporting under the relevant provisions of CAMA and/or the Listing Requirements of the NSE. He may be the statutory auditor of the company on which he is reporting or some other chartered accountants.

A Prospectus means any notice, circular, advertisement, or other invitation, offering any shares or debentures of a company/enterprise for sale or subscription. Section 650 of CAMA defines the term prospectus as:

“Any prospectus, notice, circular, and advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company and includes any document which save to the extent that it offers securities for a consideration other than cash, is prospectus”.

Issue (or offer) document means the totality of the instrument, circular, etc. by which the share and other securities of a company are offered to the public for sale or subscription.

### **Legal Requirement**

The legal requirement relating to the issue of a prospectus, as contained in the appropriate Sections and Schedules of CAMA are follows:

- (a) By virtue of Section 550(1) of CAMA, every prospectus issued by or on behalf of a company shall set out the reports specified in Part II of schedule 15 to the Act
- (b) Part II of Schedule 15 deals with the reports to be issued by the auditors of the company and is generally known as the “Accountants’ Report”
- (c) Although the Act requires the Reports to be issued by the Auditors of the company, sometimes a firm of chartered accountants other than the auditors is appointed to issue the reports either as the sole reporting accountant or jointly with the auditors
- (d) By virtue of Section 554(1), the report of the Reporting Accountant is not valid unless:
  - i. “he has given and has not, before delivery of a copy of the prospectus for registration, withdrawn his written consent to the issue thereof with the reports included in the form and context in which it is included; and
  - ii. A statement that he has given and has not withdrawn his consent appears in the prospectus”.
- (e) Section 562 of the Act provides for civil liability for misstatements in a prospectus. The reporting accountant is by virtue of this Section liable to pay compensation to all persons for any untrue statement made by him as an expert.

### **Professionalism and Excellence**

The reporting accountant should not rush to accept an appointment. Rather, he should carefully consider whether there are many matters

which prima facie, might make it difficult or impossible for him to report on the forecasts, for example:

- (a) Insufficient time allowed for obtaining and assessing information required
- (b) The nature of the business activities
- (c) Unreliable costing and accounting methods
- (d) Unreliable methods of forecasting; and
- (e) The reputation of the promoters.

It is in the interest of the auditors not to associate themselves directly or indirectly with an Issue Document unless:

- (a) Their name is mentioned in the issue document
- (b) They have been given adequate time to read the issue document and check all material facts and figures, particularly the five years financial statement (balance sheet and profit and loss accounts); and
- (c) Their consent to mention their names in the Issue document has been obtained and it is so stated therein.

### **Cautious Approach**

There is need for auditors to be very cautious in their approach to the assignment of reporting accountants. Consequently, members of the Institute, when acting as reporting accountants, must exercise great care in carrying out the investigation and analytical work that would lead to the Report required by Part II of Schedule 15 of the Act.

Furthermore, where the company is his audit client, the Reporting Accountant should ensure that, as possible and practicable, the staffs engaged on the prospectus work are not those who audit the company. This arrangement will ensure the quality and independence of the Accountant's Report.

### **Procedure**

As in the case of any investigation assignment, the assignment of a Reporting Accountant must be carefully and methodically planned. A typical outline of the work programme of a Reporting Accountant is shown below:

- (a) **General Information to be obtained**
  - i. History and nature of business
  - ii. Share capital and borrowed money (or debt capital)

- iii. Management
- iv. Employees
- v. Premises, plant and machinery or property, plant and equipment)
- vi. Raw materials and supplies
- vii. Sales; and
- viii. Other matters.

**(b) Work to be done**

- i. Preliminary enquires
- ii. Profits
- iii. Net assets; and
- iv. Taxation

**(c) Profit Forecast and Cash Flow Statement**

- i. Preliminary enquiries
- ii. Accounting principles
- iii. Forecasting procedures
- iv. Assumptions
- v. Detailed examination of profits forecast
- vi. Detailed examination of cash flow statement.

**(d) Miscellaneous**

- i. Prospectus checklist
- ii. Verification check list
- iii. Completion board meeting
- iv. Letter of consent
- v. Comfort letter
- vi. Use of firm's name.

The ICAN auditing guidelines provide as appendices the following:

- (a) Contents of a prospectus for companies applying for full listing on the Nigerian stock exchange
- (b) Contents of accountant's report
- (c) Specimen accountant's report
- (d) Specimen profit forecast letter
- (e) Specimen letter of comfort; and
- (f) Specimen letter of consent.

It is advisable for readers to familiarise themselves with all the above as shown in the appendices vi – vii (f). In that way, the various types of

contents of a prospectus will become very clear and simple to understand.

### **Detailed Programme**

In complying with the outline of the procedure given above, some of the matters which should feature in the detailed programme for carrying out the reporting accountant's investigation assignment are:

- (a) Where the reporting accountant is not the auditor, he should ensure that the auditors are notified in writing and their full co-operation with him is solicited.
- (b) Before starting work, the following documents should be read:
  - i. CAMA Sections 50, 550, 554, 557, 567, and Schedule 15;
  - ii. Nigerian Stock Exchange Listings requirements; and
  - iii. Investments and Securities Act of 1999.
- (c) Obtain the client's (or Issuing House's) written instructions and ensure that they include: time-table, scope of work, and any special instructions on confidentiality.
- (d) From copies of the audited and supporting detailed management accounts, prepare summaries of detailed trading and profit and loss accounts and balance sheets for the immediately preceding five years.

The auditor working papers for the relevant years should be reviewed to assess the reliability of the audited accounts. The accounting policies should also be reviewed for appropriateness and consistency.

Qualifications (if any) in the auditor's reports and any significant notes on the accounts should be recorded for special consideration.

- (e) The reporting accountant is obliged to make such adjustments to the profit and loss accounts and balance sheets as he considers necessary. It is however, advisable to discuss any proposed adjustments not with the client but also with its auditors. Adjustments do not necessarily mean that the audited accounts are wrong.

Adjustments would normally be necessitated by:

- i. Changes in accounting policies; and
- ii. Fundamental errors.

Changes in accounting estimates, which were properly made at the time the relevant accounts were finalised, would not normally require adjustment but may require disclosure as exceptional items.

- (f) The reporting accountant should arrange to have access to:
  - i. Statutory books including Memorandum and Articles of Association and minutes of meetings of the Board of Directors
  - ii. Tax computations and correspondence with the Federal Inland Revenue Service; and
  - iii. Copies of any relevant reports (Valuation and Feasibility Reports) prepared by outside consultants or internally, by the company.
- (g) The reporting accountant should arrange tour of factory, work, etc.
- (h) The reporting accountant should arrange attendance at all parties' meetings. The role of the reporting accountant at these meetings is to see that reasonable steps are taken to check the accuracy of figures, words and all relevant information and material facts.

### **SELF-ASSESSMENT EXERCISE**

Explain what you understand by the nature, classes and methods of investigation.

### **3.2 Examination of Financial Forecasts and Projections**

The statement of profits forecast and working capital adequacy (the financial forecasts) are undoubtedly the most important part of a prospectus. Though, the directors are solely responsible for the profit forecast and for the assumptions on which it is based, the reporting accountant must take special care in regard to this section of his work.

The main features of the work programme on financial forecast and projections including the following:

- (a) Review of underlying assumptions and outline of the company's forecasting technique and methods, for example, the existence of a budget corporate plan and its regular revision.  
Assumptions should be stated in clear and unambiguous terms to assist the reader in assessing the reasonableness of the forecast and its inherent uncertainties.
- (b) Review the accounting policies adopted in preparing the forecast and ensure they are consistent with those normally adopted by the company for preparing its annual accounts.

- (c) Compare the detailed results of the company for, the preceding three years with a view to ascertaining the trend and assessing the extent to which the company's past experience in forecasting indicates that its forecasts can be relied upon.
- (d) Compare the forecast under review with any earlier forecast made in respect of the same or over-lapping period and obtain explanations for any material changes.
- (e) When reviewing the cash forecast, the following factors must be carefully considered:
  - i. The assumptions used are the same as those used for the profit forecast
  - ii. The changes in level of stock and work-in-progress, debtors and creditors, appear reasonable having regard to the budgeted level of trading or operation
  - iii. Items such as capital expenditure, investment, taxation and dividends, are included in the correct period
  - iv. Recently announced fiscal legislations and regulations have been taken into account; and
  - v. The proforma balance sheet at the end of the profit forecast period reconciles with both profits and cash forecasts.
- (f) Obtain written confirmation from bankers and other loan creditors in respect of the overdraft and loan facilities assumed to be available during the period of the forecast.

### **SELF-ASSESSMENT EXERCISE**

Outline some of the issues that should be featured in the detailed programme for carrying out the reporting accountant's investigation assignment.

### **3.3 Forensic Investigation and Audit**

"Forensic", according to the Webster's Dictionary means, "belonging to, used in or suitable for courts of judicature or to public discussion and debate. Flowing from this, forensic accounting is seen as providing an accounting analysis that is suitable for the court and which will form the basis for discussion, debate and ultimately dispute resolution. It is actually the integration of accounting, auditing and investigative skills that has yielded the speciality known as forensic accounting.

Forensic accounting encompasses both litigation support and investigative accounting, explained thus:

- (a) Litigation support provides assistance of an accounting nature in a matter involving existing or pending litigation. It deals primarily with issues which relate to the quantification of economic damages. An example of a litigation support assignment would be the calculation of the economic loss resulting from a breach of contract.
- (b) Investigative accounting is often associated with investigations of criminal matters. Examples of investigative accounting assignments would be an investigation of employees' theft, insurance fraud, securities fraud, kickbacks and proceeds of crime investigation.

According to Alan Zysman, "forensic investigation is the utilisation of specialised investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law". Thus, a forensic investigation may be based on various fields such as accounting, engineering, medicine, or some other discipline.

On the other hand, "forensic audit is an examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court". An example would be a forensic audit of income records to determine the quantum of rent owing under a lease agreement, which is the subject of litigation.

As the definition clearly shows, a forensic audit is quite distinct from either internal audit or external audit. A typical approach to a forensic accounting assignment, as suggested by Alan Zysman will include the following steps:

- (a) Meet with the client
- (b) Perform a conflict check
- (c) Perform an initial investigation
- (d) Develop an action plan
- (e) Obtain the relevant evidence
- (f) Perform the analysis, which in turn will be dependent on the nature of the assignment and may involve:
  - i. Calculating economic damages
  - ii. Summarising a large number of transactions
  - iii. Performing a tracing of assets
  - iv. Performing present value calculations utilising appropriate discount rates
  - v. Performing a regression or sensitivity analysis:
  - vi. Utilising a computerised application such as a spread sheet, data base or computer model; and
  - vii. Utilising charts and graphics to explain the analysis.

Prepare the report which will include:

- i. nature of the assignment
- ii. scope of the investigation
- iii. approach used
- iv. limitations of scope; and
- v. Findings and/or opinion.

Prepare schedules and graphics necessary to properly support and explain the findings.

### **SELF-ASSESSMENT EXERCISE**

Outline the main features of the work programme in financial forecast and projections.

### **3.4 The Report Appropriate to Each Type of Investigation**

Each investigation assignment is unique, though some of them fall into typical cases; for example, the inclusion of the accountant's report in a prospectus and for a merger scheme. The report appropriate to each type of investigation should follow the general approach to any investigation but be specifically addressed to the nature of the assignment carried out. By way of illustration, we consider these two reports:

- (a) the Reporting Accountant's Report for the prospectus issued by Guaranty Trust Bank Plc on 11 June, 2004 for the offer for subscription of one billion ordinary shares; and
- (b) the Reporting Accounting's Report on Unipetrol Nigeria Plc for the Schedule of Merger between Agip Nigeria Plc and Unipetrol Nigeria Plc issued on 7 November, 2002.

**REPORTING ACCOUNTANT'S REPORT on Guaranty Trust Bank Plc (Copy of the letter from the Reporting Accountants) 3 May 2004**

The Directors  
Guaranty Trust Bank Plc  
Plural House  
Plot 1669, Oyin Jolayemi Street.  
Victoria Island  
Lagos

And

The Directors  
FCMB Capital Markets  
(A division of First City Monument Bank Limited)  
Primrose Tower  
17A, Tinubu Street, Lagos.

And

The Directors  
Asset & Resources Management Company Limited  
1, Mekunwen Street, Ikoyi.  
Lagos.

**Gentlemen,**

We report on the financial information set out in paragraphs 6.3 to 6.6 the financial information has been prepared for inclusion in the prospectus issue in connection with the offer for subscription of 1 billion ordinary shares Guaranty Trust Bank Plc (“the Bank”).

**Basis of preparation**

The financial information is based on the audited consolidated financial statements of the Bank for the five years ended 29<sup>th</sup> February, 2004 and has been prepared in accordance with the accounting policies set out in paragraph 6.2.

**Responsibility**

The financial statements on which our report is based are the responsibility of the Directors of the Bank who approved the issue. The Directors of the Bank and the Directors of both First City Monument Bank Limited and Asset & Resource Management Company Limited are

responsible for the contents of the prospectus in which this report is included.

It is our responsibility to compile the financial information, to form an opinion on the financial information and to report our opinion to you.

### **Basis of opinion**

We conducted our work in accordance with generally accepted auditing standards. Our work included an assessment of evidence relevant to the amounts and disclosures in the financial information. The evidence included that recorded by the auditors who audited the financial statements underlying the financial information. It also included an assessment of significant estimates and judgments made by those responsible for the preparation of the financial statements underlying the financial information and whether the accounting policies are appropriate to the Bank's circumstances, consistently applied and adequately disclosed.

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial information is free from material misstatement whether caused by fraud or other irregularity or error.

### **Opinion**

In our opinion, the financial information gives, for the purpose of the prospectus issued in connection with the offer for subscription of 1 billion ordinary shares of the Bank, a true and fair view of the state of affairs of the Bank as at the dates stated and of its profits and cash flows for the periods then ended.

Yours faithfully,

(Signed by the)  
(Reporting Accountants)

**Reporting Accountants' Report on Unipetrol Nigeria Plc**

**The following is a copy of the Report of the Reporting Accountants to the Scheme:**

**30 September, 2002**

The Directors,  
Unipetrol Nigeria Plc,  
STALLION HOUSE,  
(8<sup>th</sup> – 10<sup>th</sup> floor),  
2 Ajose Adeogun Street,  
Victoria Island-Lagos.

And

The Directors  
FCMB CAPITAL MARKETS  
(A division of First City Monument Bank Limited),  
Primrose Tower, 17A Tinubu Street.  
Lagos.

**Gentlemen,**

**PROPOSED MERGER OF AGIP NIGERIA PLC (“AGIP”) WITH UNIPETROL NIGERIA PLC (“UNIPETROL”)- ACCOUNTANTS’ REPORT ON THE FINANCIAL STATEMENTS OF UNIPETROL NIGERIA PLC FOR 5 YEARS AND 6 MONTHS ENDED 30 JUNE, 2002.**

We have reviewed the audited financial statements of Unipetrol Nigeria Plc (“the Company”) for 5 years and 6 months ended 30<sup>th</sup> June, 2002. The financial statements were prepared under the historical cost convention. Messrs XYZ (Chartered Accountants) was the auditors of the Company for all the periods of the accounts reviewed.

The summarized balance sheets, profit and loss accounts and statement of cash flows set out below are based on the audited financial statements of Unipetrol Nigeria Plc after making such adjustments, as we considered necessary.

In our opinion, the financial statements together with the notes thereon set out below, give a true and fair view of the affairs of Unipetrol Nigeria Plc and of the profit and cash flows for each of the years ended 30<sup>th</sup> June, 2002 and the state of affairs of the Company as at these dates and have been prepared on the same accounting basis normally adopted by the Company.

Yours faithfully,

(Signed by the)

(Reporting Accountant)

#### **4.0 CONCLUSION**

In his report, the reporting accountant should avoid giving any impression that the forecast is accurate since profit forecasts, by their nature, are based on subjective judgments. The reporting accountant should, however, review the underlying assumptions to ensure that there are no material omissions or unrealistic assumptions.

#### **5.0 SUMMARY**

In this unit, we discussed investigation, examination of financial forecasts and projections, forensic investigation and audit, and report appropriate to each type of investigation.

#### **6.0 TUTOR-MARKED ASSIGNMENT**

1. Forensic accounting encompasses both \_\_\_\_\_ and investigative accounting.
2. what is an investigative accounting?

#### **7.0 REFERENCES/FURTHER READING**

Institute of Chartered Accountants of Nigeria.(2004). *Advance Audit and Assurance*. Lagos: ICAN.

Izedonmi, P. F. (2001). *Auditing and Investigations: Questions and Suggested Answers*. Benin City: UNIBEN Press.

Millichamp, A. H. (2002).*Auditing*. London.

Olusanya, F. T. (2001). *Auditing & Investigation: A comprehensive Approach*. Lagos: Negro Ltd.

## **UNIT 6    INSOLVENCY**

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- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing the concept of insolvency, liquidation, and the implications of insolvency for corporate governance and going concern threats.

### **2.0 OBJECTIVES**

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

- define insolvency
- explain corporate distress
- state the causes of corporate distress
- explain the concept of receivership
- state what a debtor will do to give rise to the act of bankruptcy
- define liquidation
- outline the provision of Companies and Allied Matters Act in respect of liquidation
- discuss the implications of insolvency on corporate governance and going concern.

### **3.0 MAIN CONTENT**

#### **3.1 Insolvency**

This section of the unit covers the various aspects of insolvency. In very simple terms, insolvency is the inability of a particular person (either corporate or not) to pay debts when due. An insolvent corporate body is

a company that cannot meet its debts and other financial obligations as and when due. In the same vein, an insolvent debtor is a person or trader who is unable to pay his creditors as and when due.

An insolvent company will need to identify what the actual problems are in order to know the appropriate solution that can be embarked upon. The solutions may vary from contracting the company's management out to experts in a particular field, or carrying out a scheme of refinancing or capital restructuring, or the company facing either receivership or liquidation. On the other hand, an insolvent debtor may be declared bankrupt after he/she must have committed an "Act of Bankruptcy".

### **Corporate Distress**

In order to be tagged as successful, a company must meet its financial objectives and non-financial objectives such as its marketing objectives and its social responsibility objectives. The company's financial objectives normally take care of its profitability, which leads to its growth and survival, while its marketing objectives will focus on what the company proposes to offer to the society (be it product or service), ensuring that it is special, unique, or in high demand. Its social responsibility objectives will focus on what the company can do in terms of improving the welfare of the environment in which it operates. By a combination of all these objectives, a company should be able to continue to render services or make products acceptable to the customers, provide continuous employment to its employees and earn a reasonable level of return for its shareholders.

However, when a company cannot perform as planned or as expected, such a company is said to have failed to meet its objectives. Consequently, such a company is deemed to be experiencing corporate distress, or corporate failure or corporate insolvency.

### **Causes of Corporate Distress**

Corporate distress can be caused by either internal factor, such as bad management, inadequacy working capital at commencement, poor financial management, high gearing, over trading/expression, and lack of co-ordination at board level or external factors such as effect of government policies, effect of national and international economic climate, and lack of co-operation by foreign technical partners.

Whatever factors might have led to the condition, corporate distress always shows itself clearly in the persistence of "liquidity problem" that

the company experiences. This is really the climax of the various warning signals, which ought to have been observed and taken care of.

### **Corporate Distress Signals**

Some of the warning signals are usually felt by the company's employees. For example, delay in payment of workers' salaries and allowances, withdrawal of some of the fringe benefits, production at low capacity, and retrenchment of workers or a policy of no recruitment, no replacement and no retrenchment. In some cases, the company is unable to pay interest on loans and thereby unable to raise capital of the desired type. Such company will start reporting low profit or no profit at all, and may not be able to meet any of its social responsibility objectives. Worse still, such company may not be able to remit Pay As You Earn (PAYE) and staff pension deductions to the appropriate authorities.

### **Corporate Distress Process**

The processes involved in corporate distress vary according to the causes and symptoms displayed by any particular company. The first step is to conduct a detailed review of the situation with a view to identifying what the actual problems are. Once the problem is identified, then an appropriate solution can be embarked upon. For instance, if the problem is mainly that of poor management, the company's management may be contracted out to experts in that field; whereas if the problem is mainly that of inadequate funds, a scheme of refinancing or capital restructuring may be the solution. In extreme cases where the situation has become complicated by virtue of the complexity of problems involved, the company may have to face either receivership or liquidation.

There are ample provisions in the Companies and Allied Matters Act (CAMA), 1990 as amended guiding the appointment of receivers, receivers/managers and liquidators. As regards bankruptcy, corporate entities are excluded. Only individuals can be declared or adjudged bankrupt and the laws of bankruptcy and the laws of receivership are quite distinct from those of receivership and liquidation of companies.

### **Receiverships**

Receivership is the process by which someone (referred to as a receiver or receiver/manager) is appointed in whom is vested the legal right to "receive" property belonging to a company which cannot meet its obligations on a debenture trust deed.

In addition to the right to receive, the receiver may be given power to manage the assets coming under his control; in such cases, he is then

known as a receiver/manager. The conditions for the appointment of a receiver and manager and how they should operate are all set out in Section 387 – 400 of CAMA.

Receiverships are usually encountered as a result of an agreement, willingly entered into by a company (which wishes to borrow money for business purposes) and the lender the company, as security for the loan, agrees that the lender be given the right, in the event of its failing to adhere to the terms of the loan agreement, of appointing a receiver to take over the assets of the company with the main purpose of securing to the lender the repayment of the outstanding loan. By so doing, the company is said to “charge” its assets; the agreement itself is known as a charge or debenture, and charges may be either “fixed” or “floating”. The lender is referred to as the debenture holder.

In other words, a receiver is an individual appointed to recover sums owing to the holder of a charge (usually referred to as a debenture) over assets. The receiver may be appointed by the debenture holder under the terms of the debenture deed giving a fixed and/or floating charge over the assets or by the court.

#### **(a) Fixed Charge**

A fixed charge is a charge on one or more specific assets of the company, which should be clearly identifiable, such as leasehold or freehold property. When any property is subjected to fix charge, the company cannot deal freely with it and it must not have created any prior charge on the assets affected, nor dispose any of them without the consent of the debenture holders.

A fixed charge on any property shall have priority over<sup>4</sup> a floating charge affecting that company, unless the terms on which the floating charge was granted prohibited the company from granting any later charge having priority over the floating charge and the person in whose favour such later charge was granted had actual notice of that prohibition at the time when the charge was granted to him (Section 179 of CAMA).

#### **(b) Floating Charge**

A floating charge is an equitable charge over the whole or a specific part of the company’s undertakings and assets, including cash and uncalled capital of the company both present and future (Section 178 of CAMA). Unlike a fixed charge, a floating charge does not create a charge on any specific assets of the company, unless an event occurs on the happening of which the charge is deemed to crystallise, that is, become a fixed

equitable charge on such company's assets as are subject to the charge. Floating charges are most frequently encountered and are usually combined with a fixed charge to give a fixed and floating charge.

Examples of events that may occur and cause a floating charge to crystallise are:

- i. Appointment of a receiver; and
- ii. Commencement of liquidation.

Section 190 of CAMA requires every company to cause a copy of every instrument creating a charge requiring registration to be kept at the registered office of the company. However, in the case of a series of uniform debentures, a copy of one debenture of the series shall be sufficient.

### **(c) Appointment by a Debenture Holder under a Fixed Charge**

A debenture deed conferring rights under a fixed charge stipulates certain assets, which are pledged as security. The deed also states certain events, which will give the debenture holder the right to sell those assets and recover monies due to him. These events will be deemed to be breaches of the terms of the contractual arrangement. Once any breaches of the terms arise, a receiver may be appointed by the debenture holder. If a company has been given a fixed charge only, the charge will probably not confer on a receiver a power of management of the business as opposed to management of the properties specifically charged.

A receiver appointed under a fixed charge becomes the agent of the company although a receiver appointed under the terms of the debentures or trust deed would naturally be expected to be the agent of the debenture holders. However, in the event that the company goes into liquidation, the receiver ceases to be the agent of the company and becomes an independent principal.

A receiver appointed under a fixed charge is responsible only for the payment of the amounts owed to his debenture holder, which are covered by the debenture, together with his own costs. Therefore apart from a general duty of care he does not have any responsibility towards other classes of creditors (either preferential or not) of the company, other than to realise the best possible price at the time when he chooses to sell the assets.

**(d) Appointment by a Debenture Holder under a Floating Charge**

The type of debenture that creates a floating charge is the most common type entered into by a company and it is usually linked with a fixed charge. This arrangement permits the company to continue its business upon normal terms without constant referral back to the debenture holder.

Once the debenture holder exercises his right to appoint a receiver or receiver/manager, over the company's assets, the floating charge crystallises. No application to the court is necessary for such an action unless the debenture deed does not specify the circumstances in which a receiver can be appointed.

The receiver's powers of management will be set out in the debenture deed and care must be exercised to ensure that he does not act outside the powers thus conferred on him. His power to act as agent of the company ceases upon the company being placed in liquidation.

**(e) Appointment by the Court**

The court may, on the application of a person interested, appoint a receiver or a receiver/manager of the property or undertaking of a company if:

- i. The principal money borrowed by the company or the interest is in arrears; or
- ii. The security or property of the company is in jeopardy.

A receiver or manager of any property or undertaking of a company appointed by the court shall be deemed to be an officer of the court and not an agent of the company. He shall therefore act in accordance with the directions and instructions of the court. He shall also be personally liable for all contracts otherwise expressly provides.

**(f) Disqualification for Appointment as Receiver or Manager**

Section 387 (1) of CAMA states that the following categories of persons shall not be liable for appointment as a receiver or manager of any property or undertaking of any company:

- i. An infant
- ii. Any person found by a competent court to be of unsound mind
- iii. A body corporate

- iv. An un-discharged bankrupt, unless he shall have been given leave to act as a receiver or manager of the property or undertaking of the company by the court by which he was adjudged bankrupt;
- v. A director or auditor of the company; and
- vi. Any person convicted of any offence involving fraud, dishonesty, official corruption or moral turpitude and who is disqualified under section 254 of CAMA.

**(g) Actions Prior to and upon Appointment**

In order not to render a receivership ineffective from its inception, a receiver or manager should take steps to ensure that the lender, that is, the debenture holder has complied with all relevant legal requirements. These requirements include:

- i. Registration of the instrument of charge within 90 days as required by Section 197 of CAMA
- ii. Adequate proper final demand notice to the debtor company. Generally, a 21 days final notice is required after which the appointment of the receiver or manager is justified
- iii. Possession of the title documents to the assets charged or obtaining such documents from the debtor company; and
- iv. Avoidance of hasty appointments- under a fixed charge, the appointment shall not be effected within six months of creation of the charge, while in the case of a floating charge, the period is 12 months.

All the above-stated issues can be cleared at a pre-appointment meeting with the lender in order to put the receivership in the right direction.

Upon appointment, the receiver or manager shall ensure that notice is given to the Corporate Affairs Commission within 14 days, indicating the terms of and remuneration for the appointment, and every invoice, order for goods or business letter issued by or the liquidator of the company being a document on or in which the company's name appears, shall contain a statement that a receiver or manager has been appointed (Section 392 of CAMA).

**Bankruptcy**

Bankruptcy can be defined as a legal proceeding by which an insolvent debtor is declared bankrupt. An insolvent debtor is a person or trader who is unable to meet his liabilities, that is, unable to pay his creditors.

An insolvent debtor does not automatically become a bankrupt. Before such a person can be declared bankrupt, he/she must have committed an "Act of Bankruptcy", that is, an act or default on the part of such a debtor which is deemed to be evidence of his insolvency.

Legally, bankruptcy can be voluntary or involuntary. Voluntary bankruptcy is when the debtor brings the petition, while involuntary bankruptcy is when one or more creditors petition to have a debtor adjudged insolvent by a court.

In both cases, the purpose is to have an orderly and equitable settlement of the debtors' obligations.

**(a) Acts of Bankruptcy**

The various acts of bankruptcy arise if a debtor does any of the following:

- i. Makes a conveyance or assignment of his property to a trustee for the benefit of his creditors generally
- ii. Makes a fraudulent conveyance, gift, delivery, or transfer of his property or any part thereof
- iii. Makes any conveyance or transfer of his property or any part thereof, or creates any charge thereon which would be void as a fraudulent preference if he were adjudged bankrupt
- iv. Departs out of or makes himself absent from Nigeria, or departs from his dwelling house or place of business, or begins to keep house with intent to defeat or delay his creditors
- v. Permits execution to be levied against him, and allows the goods to be sold or held by the court bailiff for more than 21 days
- vi. Files a declaration of his inability to pay his debts, or files a bankruptcy petition against himself
- vii. Fails to comply with a bankruptcy notice served upon him; and
- viii. Gives notice to any of his creditors that he has suspended, or is about to suspend payment of his debts.

**(b) Bankruptcy Laws and their Objects**

In Nigeria, there is currently the Bankruptcy Act, 1979. Before then, there was reliance on the Bankruptcy Act 1914 and the Bankruptcy (Amendment) Act, 1926, both of the United Kingdom.

The objects of these bankruptcy laws are as follows:

- i. To set free a debtor who has become hopelessly involved in financial difficulties
- ii. To distribute his estate equitably among his creditors; and
- iii. To release him from all further liabilities in respect of his past debts.

**(c) Persons who may be declared bankrupt**

The following categories of debtors may be declared bankrupt;

- i. A debtor owing a liquidated sum of at least N2,000.00 (Two thousand Naira only)
- ii. A debtor who has committed an act of bankruptcy within 3 months before presentation of bankruptcy petition; and
- iii. Any debtor domiciled in Nigeria by means of an agent or a manager.

**Note**

The implication of the above is that companies incorporated under CAMA cannot be declared bankrupt; rather companies are wound up if they commit acts deserving such a treatment.

**(d) Persons who may Petition a Debtor**

The following categories of persons may petition a court praying that the debtor be adjudged bankrupt:

- i. An unsecured creditor may petition a debtor provided that he satisfies the following conditions:
  - He is owed a liquidated sum of at least 2,000.00 (two thousand naira only)
  - The debtor has committed an act of bankruptcy within three months before the presentation of the bankruptcy petition; and
  - At the date of the presentation of the petition, the debtor must be domiciled in Nigeria or must have carried on business in Nigeria by means of an agent or manager
- ii. A secured creditor may also petition if he has surrendered his securities or given an estimate of its value
- iii. The debtor himself may petition for a receiving order in respect of his estate, that he should be adjudged bankrupt. The petition must allege inability to pay his debts
- iv. A court may also petition if the debtor resides or carries on business for the greater part of six months preceding the petition, or he is not resident in Nigeria, or a creditor cannot ascertain his residence. In this case, action can be brought against the debtor in the High Court of Justice.

**(e) Bankruptcy of Partners**

As regards a partnership, the bankruptcy of a partner dissolves the partnership but does not necessarily make the firm bankrupt. The firm will not be made bankrupt if any one partner is able to pay the firm's debts. Consequently the bankruptcy of the firm will involve the bankruptcy of all the general partners.

The joint estate of the firm shall be applicable in the first instance in the payment of the partners' joint debt, and the separate estate of each partner shall be applicable in the first instance in the payment of his separate debt.

In the case of a surplus arising on any partner's estate, such a surplus must be transferred to the joint estate, while a surplus on the joint estate shall be shared to the partners in their profit sharing ratio.

**SELF-ASSESSMENT EXERCISE**

State the causes of corporate distress.

**3.2 Liquidation**

Liquidation can simply be referred to as the process of dismantling a business, paying off its debts in order of priority, and distributing the remaining assets in cash to the owners. As it relates to a company, this process is referred to as winding up and Section 401 – 536 of CAMA contain the various provisions on the winding up of companies.

The winding-up of a company involves the realisation of its assets and distribution with a view to terminating (or liquidating) the affairs of the company, in cooperation with its creditors, and bringing its existence to an end.

**(a) Modes of Winding Up**

The winding up of a company under Section 401 of CAMA may be effected:

- i. by the court
- ii. voluntary
- iii. subject to the supervision of the court.

Winding up by the court is usually referred to as a "compulsory winding up". Voluntary winding up, on the other hand, may take the form of either a "members' voluntary winding up" or a "creditors voluntary winding up".

**(b) Winding up by the Court**

A company may be wound up by the court under Section 408 of CAMA if:

- i. The company has by special resolution resolved that the company be wound up by the court
- ii. Default is made in delivering the statutory report to the Corporate Affairs Commission
- iii. The number of members is reduced below two
- iv. The company is unable to pay its debts
- v. The court is of the opinion that it is just and equitable that the company should be wound up.

Section 410 of CAMA provides that an application to the court for the winding up of a company shall be by the presentation of a petition by any of the following:

- i. The company
- ii. A creditor, including a contingent or prospective creditor of the company
- iii. The official receiver
- iv. A trustee in bankruptcy to, or a personal representative of, a creditor or contributory
- v. The Corporate Affairs Commission under Section 323 of the Act
- vi. A receiver, if authorised by the instrument under which he was appointed
- vii. All or any of these parties, together or separately.

The commencement of winding up by the court is provided for in Section 415 as follows:

- i. Where, before the presentation of a petition for the winding of a company by the court, a resolution for voluntary winding up has been passed by the company, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution, unless the court, on proof of fraud or mistake, thinks fit to direct otherwise (Section 415 [1]).
- ii. In any other case, the winding up of a company by the court shall be deemed to commence at the time of the presentation of the petition for the winding up (Section 415 [2]).

The consequences of winding up by the court, which normally date back to the commencement of the winding up, are listed below:

- i. Any disposition of the property of the company, including things in action and any transfer of shares, or alteration in the status of the members of the company, made after the commencement of the winding up shall be void, unless the court orders otherwise (Section 413).
- ii. Any attachment, sequestration, distress or execution put in force against the estate or effects of the company after the commencement of the winding up by the court shall be void (Section 414).
- iii. A copy of the winding up order shall be sent at once to the Corporate Affairs Commission (Section 416).
- iv. Once a winding up order is made, all pending actions against the company are suspended; and no fresh proceeding shall be commenced, except with the leave of the court (Section 417).
- v. The Official Receiver automatically takes charge of the affairs of the company as provisional liquidator if no liquidator is appointed (Section 422).
- vi. If a liquidator is appointed under Section 422, all the powers of the directors shall cease immediately, except so far as the court may be order sanction the continuance thereof (Section 422 [9]).

**(c) Voluntary Winding Up**

A company may be wound up voluntary under section 457 of CAMA:

- i. When the period, if any, fixed for the duration of the company by the articles of association expires, or the event, if any, occurs, on occurrence of which the articles provided that the company is to be dissolved and the company in general meeting has passed a resolution requiring the company to be wound up voluntarily;
- ii. If the company resolves by special resolution that the company be wound up voluntarily.

A voluntary winding up shall be deemed to commence at the time of the passing of the resolution for voluntary winding up. The consequences of voluntary winding up are:

- i. With effect from the date of commencement of the winding up, the company must cease to carry on business, except so far as may be required for the beneficial winding up (Section 460).
- ii. Any transfer of shares, not being a transfer made to or with the sanction of the liquidator, and any alteration in the status of the members of the company, made after the commencement of a voluntary winding up, shall be void (section 461).

- iii. On the appointment of a liquidator by the company in general meeting in the course of a member's voluntary winding up, all the powers of the directors shall cease except in so far as the company in general meeting or the liquidator sanctions its continuance (section 464).
- iv. In the case of a creditors' voluntary winding up, the creditors and the company at their respective meetings mentioned in Section 472 of the act, may nominate a person to be liquidator for the purpose of winding up the affairs and distributing the assets of the company, and if the creditors and the company nominate different persons, the person nominated by the creditors shall be the liquidator, and if no person is nominated by the creditors, the person, if any, nominated by the company shall be the liquidator (Section 473).

“Member's voluntary winding up” can be adopted whenever the company's directors have made a statutory declaration that the company's liabilities can be paid in full within such a period not exceeding 12 months from the date of commencement of winding up. In case where such a statutory declaration has been made, “creditors' voluntary winding up” shall be adopted.

#### **(d) Winding up subject to the Supervision of the Court**

If a company has passed a resolution for voluntary winding up, the court may on petition order that the voluntary winding up shall continue but subject to the supervision of the court (Section 486). A winding up subject to the supervision of the court shall, for the purpose of Sections 413 and 414 of CAMA, be deemed to be winding up by the court (Section 488).

Where an order is made for winding up subject to supervision, the court may, by the same or any subsequent order, appoint an additional liquidator. This liquidator shall have the same powers, be subject to the same obligations, and in all respects stand in the same position, as if he had been duly appointed in accordance with the provision of CAMA with respect to the appointment of liquidators in a voluntary winding up. The court may remove any liquidator so appointed by the court or any liquidator continued under the supervision order, and may fill any vacancy occasioned by the removal, or by death or resignation (Section 489).

#### **SELF-ASSESSMENT EXERCISE**

Outline the provision of Companies and Allied Matters in respect of liquidation.

### 3.3 Implications of Insolvency for Corporate Governance and Going Concern Threats

- (a) **Corporate Governance:** This refers to the action, manner and system of governing a corporate entity. So many definitions of corporate governance have been given but the one set out in the Principles of Corporate Governance developed by the Organisation for Economic Cooperation and Development (OECD) in 1999 is considered appropriate and given below:

“Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation ....., and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance” (OECD, 1999).

Many countries have specific rules, regulations and guidelines on corporate governance; Nigeria is not an exception. The reference to the topic here is merely as it concerns how insolvency for corporate governance can be enormous. Once there is corporate insolvency, the position of those charged with corporate governance becomes threatened. How much the effectiveness and accountability of boards of directors can be discussed when the company itself is on the verge of collapse?

In essence, therefore, insolvency should not occur when corporate governance rules, regulations and guidelines are carefully and religiously implemented. On the other hand, once insolvency has set in and it is persistent, there will be little or nothing that the corporate governance rules, regulations and guidelines can do to bring the company back to business.

In a few cases where restructuring of the company is still possible, there may be strong need for the management and the entire board of directors to be changed.

- (b) **Going Concern:** This is one of the fundamental accounting concepts referred to in the Statement of Accounting Standard (SAS) No. 1. It is defined as:

“an assumption that the business unit will operate in perpetuity, that is, the business is not expected to be liquidated in the foreseeable future”.

This concept implies that the directors of a company shall consider the company as a going concern if the company is capable of earning a reasonable net income and there is no threat from any source or intention by any person(s) to curtail significantly its line of business in the foreseeable future. If there is any reason for the directors to doubt the appropriateness of the going concern, then in preparing the financial statements they should give such information. The auditors of the company should also form their opinion on the appropriateness or otherwise of the going concern status of the company.

If a company is persistently insolvent, then both the directors and auditors should not take things for granted. Immediate remedial actions should be taken and if the situation is beyond redemption, the option of winding up should be considered and this means the company is no longer a going concern.

### **SELF-ASSESSMENT EXERCISE**

Discuss the implications of insolvency on corporate governance and going concern.

## **4.0 CONCLUSION**

In all cases of winding up of a company, the liquidator shall, within 14 days after his appointment publish in the Gazette and in two (2) daily newspapers and deliver to the Corporate Affairs Commission for registration, a notice of his appointment in such form as the Commission may from time to time approve (section 491).

## **5.0 SUMMARY**

This unit discussed the distinction between auditing and investigations; nature classes and methods of investigations; auditors' involvement with prospectus and other offer documents; examination of financial forecast and projections; forensic investigation and audit, and the report appropriate to each type of investigation.

Lastly, various legal processes involved in corporate distress; receivership and receiver/manager; bankruptcy; liquidation; insolvency and corporate governance with attendant going concern threats, were thoroughly discussed.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. What are three major stages into which the methods of carrying out an investigation assignment fall?
2. A \_\_\_\_\_ is a chartered accountant in public practice who is reporting under the relevant provisions of CAMA and/or the Listing Requirements of the NSE.
3. \_\_\_\_\_ is the process by which there is appointed someone in whom is vested the legal right to receive property belonging to a company.
4. The receiver's powers of management are usually set out in the \_\_\_\_\_ deed.
5. There are three main ways which the winding up of a company can be accomplished. What are they?

## 7.0 REFERENCES/FURTHER READING

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**MODULE 3      AUDIT AND ETHICS**

|        |  |
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| Unit 1 | Principles of Professional Ethics              |
| Unit 2 | Application of Professional Ethics             |
| Unit 3 | Local Legislations affecting Audits            |
| Unit 4 | International Legislation affecting Audits     |
| Unit 5 | Quality Control in Audit and Assurance Reports |

**UNIT 1      PRINCIPLES OF PROFESSIONAL ETHICS****CONTENTS**

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**1.0      INTRODUCTION**

In this unit, you shall be exposed to the nature of ethics as well as the different philosophical approaches by which ethics can be viewed.

**2.0      OBJECTIVES**

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

- discuss the nature of ethics
- explain the concepts of integrity, obligation, independence and public expectations
- state the importance of ethics in the practice of different professions

- outline the relevance of ethical standards in some of the statutory provisions affecting the accountants' job
- discuss the consequences of unethical behaviour.

### **3.0 MAIN CONTENT**

#### **3.1 The Nature of Ethics**

The Oxford Advanced Learner's Dictionary defines ethics as "the moral principles that control or influence a person's behaviour". It goes on to affirm that ethics is the branch of philosophy that deals with moral principles. There could be business ethics, and professional ethics. Ethics can be related to each particular profession such as accounting, medicine, engineering, etc. Other words which have been used to describe ethics are moral values, morality, rules of conduct, standards, conscience, moral code, and moral philosophy.

Ethics, as a branch of philosophy, is concerned with the study of what is either good or bad and right or wrong for human beings. The essence of ethics is to ascertain and continuously review how human beings should behave in order to lead a fulfilling life. Leading a fulfilling life will require considering others as well as oneself. It is not sufficient to think of what one considers as right or good, but the interests of others who may be affected by one's behaviour must be taken into consideration.

The development of these moral values is philosophically seen as dependent on the uniqueness of man that makes it possible for him to look for solutions to the problems in his environment. In his quest for solutions, some standards of morality are developed, consistently adhered to and they become acceptable to the whole group.

Thus what is ethically acceptable in one culture may not be ethically acceptable in another culture. Based on this postulation, the philosophical approach to ethics is usually discussed from various viewpoints. These are sometimes referred to as different schools of thought and for each school of thought, ethical theorists will be pointing to different bases for the formulation of ethics. Different terminologies are used to describe these different bases as well. For instance, ethics could be formed on the basis of deontology or teleology. Sometimes, such terms as utilitarianism and dilemma could be used. These terms are explained below:

- (a) Deontology is the theory of duty or obligation. Where ethical theories are formulated on deontological basis, an ethical requirement is justified because it is a "good theory in itself". The ethical requirement is based on the "act" and whether it is "right" or not. An example of the application of this basis is the ethical requirement for professional integrity as this connotes a sense of duty or moral obligation to act truthfully or honestly.

- (b) Teleology is concerned not with the act in itself but rather with the consequences of the particular act. Hence, it is sometimes referred to as "ends-based ethics" or "consequentialism". Where ethical theories are formulated on teleological basis, the ethical requirement on its own may neither be good nor bad in itself but the intended result of applying it is considered good. An example of the application of teleological basis to ethical requirement is when one considers the end as justifying the means.
- (c) Utilitarianism is a special version of teleology. It is involved with "maximising welfare" and sometimes loosely described as creating the greatest good for the greatest number. It is the end justifying the means to some extent too.
- (d) Dilemma is a situation in which all the available courses of action appear to include morally undesirable as well as morally desirable aspects.

In view of the fact that ethics is on its own a branch of philosophy, it is most likely and in all cases going to be true that a professional approach to viewing ethics will revert to a philosophical approach. This is because a professional approach here is seen to refer to an expert or competent approach. Therefore, the clause in the syllabus under "The Nature of Ethics" that refers to the differentiation between philosophical and professional approach may really be intended to discuss "ethics" from a professional's viewpoint, that is, to do less of theoretical expositions and apply more of practical applications, then one can refer to such authors who have written on business ethics (Elegido), ethics in organisations (Murray), accounting ethics (Maurice) and ethics in professional practices (Adewunmi, Unegbu, Omoregie, etc.). What all these authors have in common is the application of ethics to their different focal points.

A professional's approach to ethical issues concentrates on how each professional body or organisational unit tackles the problem of ethical requirements. Each professional body or organisational unit is seen as willingly embracing the idea of providing either a Code of Ethics/Professional Conduct or a Code of Practice/Conduct for its members or employees to follow respectively.

Ethics, as relates to professions shall form the basis of discussion in this Section. As regards organisational units, these could be subdivided into profit-making organisations (usually referred to as business entities) and not-for-profit organisations. For the purpose of our discussion, the former type shall be used for further illustration.

Ethics, as relates to business, is essentially, concerned with how an enterprise carries out its operations in a morally acceptable manner, ensuring that the decisions taken at all times are fair to all the parties involved. These parties usually referred to as stakeholders include the shareholders, customers, suppliers, employees, creditors, government, local community and the society as a whole. The various professionals usually occupy one position or the other from time-to-time, but more usually they are seen as performing their professional roles in or outside the various organisations.

A manager on his own, needs to be experienced and knowledgeable enough to be able to maintain high moral standards at all times; in fact he needs strength of character for this. However, when the organisation within or with which he operates has imbibed a set of moral standards for itself, it makes it much easier for each manager (or indeed each employee) to maintain high moral standards. Furthermore, if the organisation's Code of Practice or Code of Conduct has been properly developed and is being properly implemented, the Code would have included some measure of ethical standards and defined the corporate culture of the organisation.

Organisations that act ethically will not only provide the environment for its employees to act ethically but will also succeed in earning for themselves a good reputation. The multiplier effect of such a situation will also spill over to the society at large. In fact such organisations can become more productive and socially responsible in the long run.

### **SELF-ASSESSMENT EXERCISE**

- i. What do you understand by ethics?
- ii. Discuss the philosophical approach from which ethics can be viewed.

### **3.2 Concepts of Integrity, Objectivity, Independence and Public Expectations**

Elegido (1996) refers to independent and ultimate principles of business ethics as consisting of principles of solidarity, rationality, fairness or impartiality efficiency, refraining from willing harm to a human being, and role-responsibility.

In one of the Auditing Standards for professional accountants, the ethical principles which govern auditors' responsibilities are stated to include integrity, objectivity, independence, professional competence and due care, professional behaviour, and confidentiality.

The syllabus of the Institute has, however, identified four concepts under the topic of ethics for further explanation. These four are not necessarily fundamental, neither are they in the same group of consideration for any particular aspect of ethics or ethical standards. What is clear is that an understanding of these four concepts will help in appreciating the role of ethics within the context of training a chartered accountant. They are all regarded as essential in relation to ethical requirements.

### **3.2.1 Integrity**

This is an important concept that runs through the Code of Ethics or Code of Conduct of many professional bodies, for example, accountancy, banking, quantity surveying, taxation, etc. The Oxford Advanced Learner's Dictionary defines integrity as "the quality of being honest and having strong moral principles" (personal or professional integrity). Honesty (which is "being honest") on its own means truthfulness, which implies the "whole truth and nothing but the truth", (the truth as it is).

In addition to honesty, other synonyms for integrity include probity, uprightness and incorruptibility. Integrity implies not merely being honest, but fair dealing and truthfulness. It is either one has integrity or does not have it; there is no measure of it that is considered acceptable. Therefore, a professional should aim at simply being a person of integrity, rather than seeking to be operating at any acceptable level of integrity. He/she should deal with any situation with all sincerity of purpose, being transparently honest.

Each professional body expects that its members will at all times conduct themselves in such a way that will not bring discredit to the professional body. Members should not only be honest but must be seen to be honest in all their dealings with others. Examples abound from one profession to another, such as "a chartered tax practitioner must not act for both a taxpayer and Revenue Service simultaneously in respect of tax matter"; a journalist "shall use only fair and honest methods to obtain news, pictures and documents"; a member of the Nigerian Institute of Building "shall at all times act with integrity so as to uphold and enhance the dignity, standing and reputation of the building profession"; and a Chartered Accountant "should behave with integrity in all professional and business relationships".

The integrity of an individual manager or professional has interplay with the organisation in which he operates as well as the society at large. What type of organisation is it? Is it an organisation that has a code of conduct or code of ethics? How does the management of the

organisation feel about integrity? Is it a place where there is absolutely no set of ethical standards for the way business is done? The tendency has always been that the society respects a rich or wealthy man without caring to know how he got his riches. The day that each individual or professional starts to take the issue of integrity, seriously that day will be the beginning of and indeed a turning point to the right direction for our society in terms of integrity.

### **3.2.2 Obligation**

This means a law or a promise, or an influence that forces one to do something. It also means a duty for example, fulfilling one's professional obligations. In relation to ethical requirements, obligation can also be seen as a responsibility or a compulsion.

An individual in the process of being ethical may consider his obligation of keeping promises while in the case of an organisation, it may be necessary to ask if we consider that an organisation has an ethical obligation to be socially responsible. The point has been made earlier in this chapter that ethical requirements make it necessary for one not to be thinking of being good to himself alone, but also to others. In view of this it becomes necessary to see organisations as needing to consider how they can be of any use to their immediate environment.

The professional should be able to ascertain from time to time if he is under obligation to do certain things. This becomes more pertinent when he/she is under pressure to do things, which by virtue of the provisions of the Code of Conduct of his professional body, he is precluded from doing.

### **3.2.3 Independence**

This refers to the state of not being controlled by other people or things, such as financial benefits. A professional needs to be objective in the course of performing his/her duties. Such a professional after behaving objectively will need to be independent of the owners of the business for which he/she is working. Objectivity and independence often go together and chartered accountants and especially auditors should not only be objective but also act independently of the entity they are working for. It is in the interest of the public at large that if the work of professionals should be relied upon by the same public, those professionals should be independent of their clients in the way they conduct themselves.

As in the case of integrity, the society poses some threats to the independence of professionals while it is the responsibility of the individual professionals and their professional bodies to ensure that

necessary safeguards are put in place to reduce the risk involved.

The Code of Ethics of the International Federation of Accountants (IFAC) states that independence requires:

- (a) "Independence of mind: The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- (b) Independence in appearance: The avoidance of facts and circumstances that are so significant that a reasonable informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude that a firm's integrity, objectivity or professional scepticism had been compromised."

In other words, a professional should not only be independent, but must be seen to be independent.

### **3.2.4 Public Expectations**

The society at large should be in a position to expect individual professionals and organisations to comply with some form of ethical standards. This is because of the fact that neither the individual professional nor the organisational unit can operate without affecting or being affected by the environment in which either of them operates. That environment may be small or big, may be heterogeneous or homogeneous. The important thing is that the environment has its own expectations.

An individual professional is expected by the public to possess certain attributes, some of which are integrity, objectivity, independence, technical and professional competence. He/she is expected to be able to avoid disclosing confidential information about his/her clients' business, employers or customers business indiscriminately. Imagine a doctor, a banker, an accountant, etc., not being able to keep information confidential.

The public (in the various forms of stakeholders) also expect that information provided by a professional will be true and accurate. An engineer's report on a project, a doctor's report on a patient, an estate valuer's valuation report on a piece of property, a lawyer's report on a case, etc. are all examples of information provided by professionals which the public expect to be true and accurate. Truthfulness in this case is expected to be what indeed is true, not what ought to be true. This requires integrity, that is, probity, honesty, incompatibility, or uprightness.

In fact each individual is expected to be morally good, morally fair and to prefer to choose good over evil. For instance the public expects people to say the truth at all times.

### **SELF-ASSESSMENT EXERCISE**

Explain each of the ethical principles in your own understanding.

### **3.3 Ethics and the Professions**

Profession is a paid occupation that requires advanced training and education. A profession has been defined in differing ways by various authors, though each attempt is still revolving round the one quoted above. A clearer understanding of it is however provided when one considers the premises upon which the idea of a profession rests. Millichamp (1990) revealed that a profession has the following characteristics:

- (a) A recognisable discrete body of knowledge
- (b) An educational process
- (c) A system of examinations
- (d) A system for licensing practitioners
- (e) A professional association
- (f) A sense of responsibility to society
- (g) A code of ethics
- (h) A set of technical standards.

The members of a profession usually endorse a code of ethics governing their professional behaviour. They define the area of their technical competence, ensuring from time to time that those who possess the required formal educational qualifications and appropriate practical experience are given the right to practice within the stipulated code of ethics.

Another attempt at defining a profession as provided by Okogwu is to see it as an "occupation requiring specialised knowledge that can only be gained after intensive preparation". Professional occupations tend to possess three features:

- (a) A body of erudite knowledge which is applied to the service of society;
- (b) A standard of success measured by accomplishment in serving the needs of society rather than purely serving personal gain; and
- (c) A system of control over the professional practice which regulates the education of its members and maintain both a code of ethics and appropriate sanctions:

Professional ethics or the ethics of any particular profession regulate the way and manner each member is to relate to other members on the one hand and to the society on the other, both from a moral perspective. Morality is the bedrock of all the issues about ethics. The type of questions that usually arise are in the realm of choosing or deciding to do what is considered to be good, right, fair, and acceptable. The age long biblical golden rule of -"doing unto others what you want others to do to you" or "whatever you want men to do to you, do also to them", seems to be appropriate in discussing ethics.

This is because there is really nobody that would prefer other people not to be fair to them, or not to do good things to them or to do them any wrong. This is why ethical issues do not stop at what one does to have a fulfilled life but also how what one does affects other people.

Any misconduct committed by members of a profession will tend to bring both the affected members and their profession to disrepute or discredit. An individual professional can become more respectable and be counted among those people of integrity by maintaining high ethical standards in a consistent manner.

### **SELF-ASSESSMENT EXERCISE**

What is the relationship between ethics and profession?

### **3.4 Ethics and the Law**

The questions may be asked: Has law got anything to do with ethics? Can matters of ethics constitute areas in which governments might legislate for improved standards of behaviour? The answers to these questions are no doubt in the affirmative. According to Murray (1997), "a civilised economic system needs a legal framework which while providing for initiative and enterprise, will curb the worst excesses. This, however, must be supplemented by a general acceptance among business people at all levels that many areas outside legislative control should be policed by shared values such as integrity, fairness, honesty, stewardship, respect for human dignity and concern for others".

Some professions are regulated while others are not. In the case of the regulated professions such as accountancy, banking, law and medicine the distinction between statutory and ethical requirements may not be as clear as in the case of the less regulated professions. In the regulated professions a lot of their ethical requirements have a statutory basis.

There are many examples of the statutory basis of the ethical requirements of some of the professions, spanning through the

provisions of CAMA, BOFIA, CBN Act, and the enabling Act of each of the professional bodies (ICAN Act, CIBN Act, etc).The following are examples of statutory provisions which reflect some ethical rules or standards:

- (a) Sections 331- 369 of CAMA provides extensively for financial statements and audit. One of such provisions is that "an officer of a company commits an offence if he knowingly or recklessly makes to a company's auditors a statement (whether written or oral) which:
  - (i) Conveys or purports to convey any information or explanation which the auditors require, or are entitled to require, as auditors of the company; and
  - (ii) Is misleading, false or deceptive in a material particular.
- (b) Sections 615 and 616 of CAMA prohibit insider trading and the abuse of privileged information by an insider of any company registered under the Act.
- (c) Various provisions abound in both the CBN Act and BOFIA governing the operations of banking business in Nigeria.
- (d) Provisions of the Insurance Act, 2003 stipulate how insurance business should be carried out.
- (e) The Securities and Exchange Commission (SEC) requires full public disclosure of specified items of accounting information by companies offering their shares for the first time in the Nigerian securities market.
- (f) The Nigerian Stock Exchange (NSE) regulates items that quoted companies must disclose in published accounts in addition to those statutorily specified by CAMA.
- (g) The Audit Committee has as one of its objectives and functions (as provided for in Section 359(6) of CAMA), the ascertainment of whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices.

In addition to self-regulation in a given profession, the professional who, working with a client that operates in a regulated sector also has to exercise due care and diligence that such client are compliant with both the law and the regulations affecting them. A good example of this situation is when an auditor is working for a bank where BOFIA, CBN Act, NDIC Act and CAMA are not sufficient, but all the circulars from CBN and NDIC have to be reckoned with.

Furthermore, there may be statutory prohibitions on an individual professional or his firm while performing their professional duties. For instance, Section 358 (2) of CAMA prohibits an officer or employee of a company or a partner or employee of such a person, from accepting appointment as auditor of that company.

The state of being law-abiding is not sufficient for the society to accept individuals or organisations who want to operate at any level of society to adopt behaviour of inhumanity or immorality as they please. Even if they do not break explicit laws, the fact that their actions are either inhuman or immoral shall be sufficient for the society to frown on them.

### **Note**

The duty of creating and sustaining an ethical environment is for us all to share equally and generally. It calls for the dedication of all of us, regardless of our position in the society.

### **SELF-ASSESSMENT EXERCISE**

Explain your understanding of the relationship between ethics and Law.

### **3.5 Ethics and the Professional Accountant**

In the conduct of any of the professional duties of a Chartered Accountant, for example, financial accounting, auditing, taxation etc., he/she must comply with the ethical guidance issued by his/her professional body. For instance, the International Standard on Auditing (ISA) No. 200 titled *Objective and General Principles of Audit* provides that "in the conduct of any audit of financial statements auditors should comply with the ethical guidance issued by their relevant professional bodies".

The ethical principles that govern auditors' professional responsibilities are provided to serve as guidance to the chartered accountant while providing auditing and related services. However, a chartered accountant performing non-audit functions is also to be guided by the professional code of conduct of the Institute.

The International Federation of Accountants (IFAC), which is the international body comprising about 150 member organisations from all over the world, representing over 1.5 million professionally qualified accountants, has its own Code of Ethics for professional accountants. This Code is binding on all the IFAC member bodies, and the latter are obliged to ensure that either in the form of their own local Code or

directly by adopting the IFAC Code, their own members are appropriately guided to comply with the IFAC Code.

In the case of Nigeria, and in view of the fact that ICAN is the only Nigerian accountancy body recognised by IFAC, there is a Code of Professional Conduct for Members issued by ICAN. This Code draws mainly from and conforms to the guidelines of IFAC.

Professional accountants are required to observe the ethical standards of their professional body. By extension, chartered accountants in Nigeria are required to observe and comply with the ethical standards of ICAN. Some of these ethical standards (or most of them) are written while some are unwritten. In paragraph 5 of the Introduction to ICAN's Code, it is stated that the guidance on professional conduct is not exhaustive as members are admonished to "be guided not merely by the terms, but also by the spirit of this Guide and the fact that a particular conduct does not appear among a list of examples does not prevent it from amounting to misconduct". In fact paragraph 20 of the same section of the Code states by way of *Further Advice* that "a member who is in doubt as to his or her ethical position in any matter may seek advice of the Institute through the Registrar/Chief Executive".

In spite of the fact that misconduct is difficult to define and the Code has subtly warned that ignorance of misconduct or its omission from the list of examples does not absolve any member from sanction, professional accountants are urged to refrain from misconduct. Misconduct is seen as including any act or default which is likely to bring disrepute to him, his fellow accountant, and the profession of accountancy in general.

Millichamp (1996) has made some general points on ethics and the professional accountant. They are as stated below:

- (a) Integrity is vital;
- (b) Professional independence is very important;
- (c) Accountants must not only be people of integrity and independence; they must also be seen to be so; and
- (d) when a professional accountant has ethical difficulties or is uncertain about the course of action to take, he should either seek advice from his professional body or even take legal advice.

### **3.6 Consequences of Unethical Behaviour**

The consequences of unethical behaviour are reflected not only on the individual but also on his profession, his professional body and indeed the society at large. The first thing to consider here is what constitutes an unethical behaviour. An understanding of ethics could be presumed

to be a pre-requisite of understanding what can constitute an unethical behaviour.

In a study involving different categories of players in the financial services industry, Adewunmi (1998) was able to identify various types of description of unethical behaviour. Some of them that are of general application are:

- (a) Any act or behaviour which is not in consonance with professional code of conduct;
- (b) Behaving in ways outside the moral principles or ethics which govern a certain profession;
- (c) Any act that does not follow the norms of a profession;
- (d) A behaviour that negates the code of conduct guiding an operation.,
- (e) Any attitude that is not in consonance with the accepted norms;
- (f) A conduct that is morally adjudged wrong, unbecoming and below expectation;
- (g) Behaviour that is not based on moral principles;
- (h) Deviation from standard and known norms; and
- (i) An act that is not normally right.

The above list shows clearly that in each case, there has been an attempt to see unethical behaviour as the opposite of ethical behaviour. The major attributes of unethical behaviour as behaviour refer to failure to comply with the expected normal moral standards of a profession. It is simply a professional misconduct.

The consequences of failure to comply with the ethical standards of a profession can be clearly identified from the Code of Conduct or Code of Ethics of that profession. Using the ICAN Code and chartered accountants as an illustration here, the section on *Enforcement of Ethical Standards* is reproduced below:

“This statement shall apply to all members:

- 1.1 The power of the Institute to enforce ethical standards is by the ICAN Act conferred on the Accountants' Disciplinary Tribunal which is in respect of this power independent of the Council.
- 1.2 The Investigating Panel considers complaints against the conduct of members, and is empowered to initiate disciplinary action by referring appropriate cases to the Disciplinary Tribunal for adjudication.
- 1.3 Where a complaint is received by the Institute alleging a case of misconduct against a member, such a member shall be requested by the Investigating Panel to furnish his defence or reaction to the

- complaint within 14 days of the receipt of the request to do so if the member is resident within Lagos State or twenty one days if the member is resident outside Lagos State.
- 1.4 If the member fails to respond within the specified time, a first reminder shall be sent to him requesting him to send his defence/reaction within 7 days from the receipt of the reminder. If the member fails to respond again, a second reminder shall be sent to him requesting him to send his defence/reaction within seven days ultimatum within which to reply and a warning that non-response shall amount to contempt of the Institute and is sanctionable by the Disciplinary Tribunal.
  - 1.5 If the member fails to respond after the second reminder, a formal charge of contempt shall be preferred against the member before the Disciplinary Tribunal.
  - 1.6 The provisions and/or procedures contained in paragraphs 1.4 and 1.5 above shall apply to any other requirement or directive of the Panel to a member so much so that failure or neglect by the member to abide by the requirement or directive shall also be treated as contempt of the Institute and could be sanctioned by the Disciplinary Tribunal.
  - 1.7 If having considered the facts before it, and any representation made by the member, the Panel is of the opinion that in all the circumstances those facts amount to misconduct and is of the further opinion that disciplinary proceedings should be brought, it will prefer a formal complaint to the Disciplinary Tribunal. Alternatively, the Panel, if it considers that the case does not call for the most serious sanctions, may make certain orders against him.  
In cases which give rise to or include questions of public concern, the Panel may alternatively refer the matter to the Disciplinary Tribunal.
  - 1.8 It is the Disciplinary Tribunal which, alone, can determine, subject to the right of appeal referred to below, whether a complaint of misconduct is proved.
  - 1.9 Where a complaint is against the conduct of a firm having more than one partner, the complaint shall be deemed to have been made against each and every member who was a partner in the said firm at the material time, for the purposes of this statement.
  - 1.10 From the Accountants' Disciplinary Tribunal, a member has a right of appeal to the Court of Appeal (See Section 12(5) of the ICAN Act).

Any failure to follow the guidance in the Fundamental Principles or in the Statements may also be taken into account by the Committee of the Institute responsible for regulating the work of members and member firms (ICAN, 1999, pp.79-80)".

The Accountants' Disciplinary Tribunal has powers equivalent to those of a High Court and that is why any appeal against its verdict goes to the Court of Appeal, and thereafter to the Supreme Court. Consequently, the normal rules of evidence are applicable; all complaints should be in writing while any accusation against any member should be substantiated with documentary evidence.

Sanctions which are commonly imposed by the Institute for misconduct include the following:

- (a) Reprimand;
- (b) Payment of costs;
- (c) Fine;
- (d) Withdrawal of practising rights;
- (e) Suspension from membership for a period of time; and
- (f) Expulsion from membership.

The above consequences could be seen as affecting the individual chartered accountant alone. However on a deeper reflection, it will be observed that the profession as well as the entire society would have suffered one form of disadvantage or the other if a single professional accountant has been found guilty of professional misconduct.

Some of the disadvantages to the profession and society are:

- (a) Each time a professional accountant (or any other professional for that matter) is found guilty of misconduct, any type of sanction meted out to him has ripple effects on his immediate family, business and the economy. He might have ended up losing his practising licence or getting his name struck off from the register; this is a loss of income for him. If serious enough, his professional misconduct could have affected the going concern status of his firm.
- (b) A misconduct of a professional that affects the going concern status of his firm affects the various stakeholders in that firm. For example, the creditors may not be able to receive all that is due to them, the partners may lose either all or a substantial part of their capital while the employees as a whole may lose their jobs.
- (c) The economy suffers from this type of scenario, the loss of income to government either on the employees' personal income tax or the partners' income tax (if in partnership).
- (d) Any or all of the above situations will have adverse effect on the particular profession of the affected individual.

## **SELF-ASSESSMENT EXERCISE**

Outline the consequences of unethical behaviour.

### **4.0 CONCLUSION**

The unit critically examined the nature of ethics; concepts of integrity obligation, independence and public expectations; ethics and the professions; and ethics and the law.

### **5.0 SUMMARY**

In this unit, we have further reviewed ethics vis-a-vis the professional accountant; consequences of unethical behaviour; ethical standards and professional responsibilities of the chartered accountant as well as his/her relationship with fellow members.

### **6.0 TUTOR-MARKED ASSIGNMENT**

1. According to the Code of Ethics issued by the International federation of Accountants, (IFAC), independence requires both independence of \_\_\_\_\_ and independence in \_\_\_\_\_.
2. Professional regulate the way and manner each member is to relate to other members on the one hand, and to the society on the other, both from a moral perspective.

### **7.0 REFERENCES/FURTHER READING**

- Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.
- ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 2 APPLICATION OF PROFESSIONAL ETHICS**

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### **1.0 INTRODUCTION**

In this unit, you will learn ethical standards and professional responsibility. You will also be made to understand the relationship among fellow members. Lastly, we also discuss the meaning of Corporate Governance, the need for it and the best practices on Corporate Governance.

### **2.0 OBJECTIVES**

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

- describe the ethical standards required of accountants and the related professional responsibilities; as they affect the professional Accountants
- discuss the type of relationship that professional accountants could have with fellow members
- explain the concept and role need for corporate governance.
- Analyse the role of board of directors, shareholders, and audit committee in corporate governance.

### **3.0 MAIN CONTENT**

#### **3.1 Ethical Standards and Professional Responsibilities**

The ethical standards as contained in the ICAN Code are in two categories, namely:

- (a) Fundamental Principles
- (b) Statements.

##### **3.1.1 Fundamental Principles**

These are drawn from the duties owed by all members of the profession, whether in practice or not. They are framed in broad and general terms and constitute basic advice on professional behaviour. These principles stipulate that a member of the Institute should:

- (a) Behave with integrity in all professional and business relationships. Integrity implies not only honesty but fair dealing and truthfulness;
- (b) Strive for objectivity in all professional and business judgements. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other;
- (c) not accept or perform work which he or she is not competent to undertake unless he/she obtains such advice and assistance as will enable him/her to competently carry out the work;
- (d) carryout his or her professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member; and
- (e) conduct himself or herself with courtesy and consideration towards all with whom he comes into contact during the course of performing his work.

##### **3.1.2 Statements**

These provide more details on what is expected of members in certain circumstances. They are for the most part in the form of principles followed by discussion and illustrations. Most of the Statements are relevant to members engaged in practice and also, where appropriate, to employees of practising firms but not to other members. The various sections of the Statements and their respective subject matters, showing those to whom they are applicable are shown on Illustration 5.8.

The fundamental principles in the Code have already indicated that the following ethical principles are essential for members:

- (a) Integrity;
- (b) Objectivity;
- (c) Technical or professional competence;
- (d) Due skill, care and diligence; and
- (e) Professional behaviour.

Though, the first two are also mentioned under the Statements, there are other ethical standards which are not specified under the fundamental Principles, but mentioned under the Statements only.

These are:

- (a) Independence; and
- (b) Confidentiality.

Statement No. 1 is titled *Integrity Objectivity and Independence*. Under it, the various explanations of integrity and objectivity already-given under the Fundamental Principles are re-presented. However, independence is given prominence as it is merged with objectivity and related to the various functions performed by a professional accountant, that is:

Section A – Objectivity, Independence and the Audit

Section B – Objectivity and Independence in financial reporting and similar non-audit roles.

Section C – Objectivity and Independence in professional roles other than those covered in Sections A and B.

The above are further explained in the table below:

**Table 2.1: Analysis of the Statements of Ethical Standards**

| Number | Subject Matter  | Those to Whom Applicable   |
|--------|---|--|
| 1.     | Integrity, Objectivity and Independence<br>Preface – Integrity, Objectivity, Framework etc.   | All Members  |
|        | Introduction – Safeguarding Objectivity<br>Section A – Objectivity & Independence & the Audit | All Members, Practising Members Affiliates and Employees of Practising Firms |
|        | Section B – Objectivity & independence in financial   | Practising, Members Affiliates and Employee of                               |

|     |   |   |
|-----|---|---|
|     | Reporting & similar Non-Audit Roles   | Practising firms  |
|     | Section C – Objectivity & independence in Professional Roles other than covered in Sections A & B | Practising Members, Affiliates and Employees of Practising Firms. |
|     | Section D – Definitions   | All Members   |
| 2.  | Conflicts of Interest   | Practising Members, Affiliates and Employees of Practising Firms  |
| 3.  | Confidentiality   | All Members   |
| 4.  | Changes in a Professional Appointment   | Practising Members, Affiliates and Employees of Practising Firms  |
| 5.  | Consultancy   | Practising Members, Affiliates and Employees of Practising Firms  |
| 6.  | Associations with Non-Members   | Practising Members, Affiliates and Employees of Practising Firms  |
| 7.  | Fees  | Practising Members, Affiliates and Employees of Practising Firms  |
| 8.  | Obtaining Professional Work   | Practising Members, Affiliates and Employees of Practising Firms  |
| 9.  | Names and Letterheads of Practising Firms   | Practising Members, Affiliates and Employees of Practising Firms  |
| 10. | Second and Other Opinions   | All Members   |
| 11. | Members in Business   | Members in Business   |
| 12. | Enforcement of Ethical Standards  | All Members   |

Each of the ethical principles is discussed below:

### 3.1.3 Objectivity

An auditor's objectivity must be beyond question when conducting an audit. An auditor must always approach his work with integrity and objectivity. Objectivity is essential for any professional person exercising professional judgement. It is equally important for accountants in business as well as those in public practice. It is the state of mind that has regard to all considerations relevant to the task in hand but no other.

It is sometimes described as "independence of mind"(ICAN). There is no doubt that the need for objectivity is particularly evident in the case of an auditor whose work entails giving a professional opinion that is likely to affect rights between various parties and the decisions they take (ICAN, 1999).

It has become clear that there are sometimes instances of threats to objectivity. These threats may arise in relation to the auditor's own person or in relation to a connected person such as a member of his family or a partner or a person who is close to him for reasons of past or present association, obligation or indebtedness. Threats to objectivity, as articulated in ICAN's *Rules of Professional Conduct for Members* include the following:

- (a) Self-interest threat
- (b) Self-review threat
- (c) Advocacy threat
- (d) Familiarity or trust threat
- (e) Intimidation threat
- (f) The self-interest threat is a threat to the auditor's objectivity stemming from a self-interest conflict. This could arise from a direct or indirect interest in the shares of a client or from a fear of losing a client because of the significance of its fee as part of the firm's income.
- (g) The self-review threat is the apparent difficulty of maintaining objectivity and conducting what is effectively a self-review if any product or judgement of a previous audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching audit conclusions.
- (h) The advocacy threat occurs when there is an apparent threat to the auditor's objectivity, if he becomes an advocate for (or against) his client's position in any adversarial proceedings or situations. Whenever the auditor takes a strongly proactive stance on the client's behalf, this may appear to be incompatible with the special objectivity that audit requires.
- (i) The familiarity or trust threat is a threat that the auditor may become over-influenced by the personality and qualities of the directors and management, and consequently too sympathetic to their interest. On the other hand, the auditor may become too trusting of management representations so as to be inadequately rigorous in his testing of them because he knows the client and/or the issue too well or for some similar reason.
- (j) The intimidation threat is the possibility that the auditor may become intimidated by a dominating personality, or by other pressures, actual or feared, by a director or manager of the client or by some other party.

### 3.1.4 Independence

An auditor must always approach his work with objectivity and independence. The approach must be in a spirit of independence of mind, whereby auditors express opinions independent of the entity and its directors. However, it has been observed that it is not always an easy task for the auditor to exercise this independence; there are usually some matters, which may threaten or appear to threaten the independence of an auditor. According to Millichamp (1996), these matters include:

- (a) Undue dependence on an audit client. Public perception of independence may be put in jeopardy if the fees from any one client or group of connected clients exceed 15% of gross practice income or 10% in the case of listed or other public interest companies. This general observation needs modifying in the cases of new practices. ICAN has put this percentage at 25% (ICAN 1998).
- (b) Family or other personal relationships. It is desirable to avoid professional relationships where personal relationships exist. Examples of personal relationships include mutual business interests with members of the group comprising the client, the audit firm, officers or employees of the client, partners or members of staff of the audit firm.
- (c) Beneficial interests in shares and other investments. In general, partners, their spouses, and minor children should not hold shares in or have other investments in client companies. An audit staff member should not be employed on an audit if the staff member or some person connected with him has a beneficial interest in the audit client. Some company articles require the auditor to have a qualifying shareholding. In such cases the minimum only should be held and the holding should be disclosed in the accounts.
- (d) Loans to and from clients. An auditing practice or anyone closely connected with it should not make loans to its clients nor receive loans from clients. The same applies to guarantees. Overdue fees may in some circumstances constitute a loan.
- (e) Acceptance of goods and services. Goods and services should not be accepted by a practice or by anyone closely connected with it unless the value of any benefit is modest. Acceptance of undue hospitality poses a similar threat. A bottle of Scotch at Christmas is acceptable but a weekend in Cape Town or Obudu Cattle Ranch would probably not be.
- (f) Actual or threatened litigation. Litigation or threatened litigation, for example, on auditor's negligence between a client company and an audit firm would mean the parties being placed in an adversarial situation which clearly undermines the auditor's objectivity.

- (g) Influences outside the practice. There is a risk of loss of objectivity due to pressure from associated practices, bankers, solicitors, government or those introducing business.
- (h) Provision of other services. This is acceptable in principle but care has to be taken.
- (i) Receipt of reward from a third party other than the client. Auditors should not allow their judgement to be swayed by the receipt of a commission, fee or other reward from the third party as a result of advising a client to pursue one course rather than another. If a commission is to be received the accountant should, either give it to the client or, with the client's express or implied consent, retain it. If it is to be retained then the fact of a payment of commission, and the amount or how it is to be calculated, should be disclosed to the client, preferably in the letter of engagement. The client should consent to retention.

Audit firms should review on an annual basis every client to determine if it is proper to acceptor continue an audit engagement bearing in mind actual or apparent threats to both audit objectivity and independence. The *Rules of Professional Conduct for Members of ICAN* should always be followed.

### **3.1.5 Safeguards to Independence**

There are various safeguards available to offset the different types of threats enumerated above. Auditors should always consider the use of safeguards and procedures, which may negate or reduce threats. They should be prepared to demonstrate that in relation to each identified threat; they have considered the availability and effectiveness of the safeguards and procedures and are satisfied, that their objectivity in carrying out the assignment will be properly preserved.

#### **(a) Safeguards and Procedures in Individual Firms**

The safeguards and procedures might include the environment of the practice firm within which the professionals operates so as to offset any threat to objectivity. Though it is not possible to provide an exhaustive list of these factors, but auditors should expect where possible to have developed the following characteristics in their firms.

Where they have been developed, they will provide the necessary safeguards.

- (i) Chartered accountants are taught from the onset of their training contracts to behave with integrity in all their professional and

- business relationships and to strive for objectivity in all professional and business judgement. These factors rank highly in the qualities that the chartered accountants have to demonstrate prior to admission.
- (ii) Engagement partners should have sufficient regard for their own career and reputation to be encouraged towards objectivity and to effective use of safeguards.
  - (iii) Within every firm, there, should be strong peer pressure towards integrity. Reliance on one another's integrity should be the essential force, which permits partners to entrust their public reputation and personal liability to each other.
  - (iv) Firms should set great store by their reputation for impartiality and objectivity. It is the foundation for their ability to practise and to gain work over the medium and long term, and they should not permit a member of the firm to risk it for short-term benefit or gain.
  - (v) Firms of all sizes should have established strong internal procedures and controls over the work of individual principals, so that difficult and sensitive judgements are reinforced by the collective views of other principals, thereby also reducing the possibility of litigation.
- (b) Safeguards and Sanctions Built into the Structure of the Profession itself**

These may include:

- (i) The longstanding code of ethics of the profession-which also incorporates the "*Rules of Professional Conduct for Members*". Where appropriate, these rules impose specific prohibitions where the threat to the auditor's objectivity is so significant, or generally perceived to be so, that no other appropriate safeguards would be effective.
- (ii) The ethical support provided by the Institute.
- (iii) The reinforcement given to the above safeguards by a policing system which reacts to complaints, whether by members of the public or members of the profession investigates the background to the complaints, and where, necessary commences disciplinary proceedings against an offending member. Together with monitoring, the system ensures that a firm's past conduct and current procedures are likely to come under close scrutiny if the conduct of practising members gives rise to challenge as regards exercise of these guidelines.
- (iv) The active monitoring procedures conducted by the profession for activities such as auditing. On behalf of the

Institute, the Professional Practice Monitoring Committee may visit firms which conduct audits and examine firms' compliance with auditing guidelines and standards.

### **3.1.6 Confidentiality**

Statement No. 3 of the ICAN's Rules of Professional Conduct for Members is on confidentiality and it is applicable to all members. It gives guidance on how members should handle confidential information. Information that is confidential to a client or employer and acquired in the course of professional work should not be disclosed by a member except where consent has been obtained from the client, employer or other proper source, or where there is a legal right or duty to disclose. In the latter case, the client or employer should first be notified before disclosure is made.

It is possible for a member to be in doubt as to whether he/she has a right or duty to disclose information. Under such a circumstance, he/she should take legal advice or consult the Institute for advice. A member who has acquired or received confidential information in the course of his/her professional work should neither use nor appear to use that information for his/her personal advantage or for the advantage of a third party.

A member should not deal in the shares of a company with which he has a professional association at such a time or in such a manner as might make it seem that he was turning to his advantage information obtained by him in his professional capacity. Most importantly, it should be noted that it may be a criminal offence in certain circumstances to use confidential information for an improper purpose.

### **3.1.7 Consultancy**

Statement No. 5 of the ICAN's Rules of Professional Conduct for members is on consultancy but it is applicable to practicing members, affiliates, and where applicable, employees of practicing firms. It states that if a member in practice, that is, the practitioner obtains the advice of another member in this case, the consultant on a consultancy basis on behalf of a client, the consultant or any practicing firm with which he or his consultancy organisation is associated should not, without the consent of the practitioner, accept from that client within one year of completion of the consultancy assignment any work which was, at the time the consultant was first retained in relation to that client's affairs, being carried out by the practitioner.

The same considerations apply where a practitioner introduces one of his clients to the consultant for the purpose of consultancy.

### **SELF-ASSESSMENT EXERCISE**

The ethical standards as contained in the ICAN Code of Conduct are in two main categories. State the two categories.

#### **3.1.8 Other Professional Responsibilities**

There are laid down ethical standards covering the following professional responsibilities:

- (a) Obtaining (or securing) professional work is covered in statement No. 8 of the ICAN Code, which is applicable to practising members, affiliates, and where applicable, employees of practising firms.

A chartered accountant is guided in the way he handles various methods of obtaining professional work such as seeking publicity through advertising his or her services, achievements and products. Advertisements should be legal, decent, dear, honest, and truthful. Promotional materials should not make disparaging references to or disparaging comparisons with the services of others. There shall be no harassment of a prospective client, no cold calling, that is, unsolicited contact through phone or personal visit) of a non-client with a view to obtaining professional work from him. Any of these would constitute misconduct.

Even when trying to obtain non-audit work, for example, insolvency assignments or appointment as receivers and liquidators, members of the Institute should exercise due care. For instance appointment of a partner of a firm as receiver or liquidator should not be accepted if at any time within the preceding two years, the following situation subsisted:

- (i) A member firm acted as auditor to the insolvent company.
- (ii) A partner or employee of a member firm has been a director of the insolvent company.
- (iii) A partner has been Receiver of any asset or undertaking of the company (in the case of liquidator).

If the liquidation is a members' voluntary winding up, there will normally be no objection to a partner in the firm acting as a liquidator.

- (b) Disciplinary procedures are covered in Statement No. 12 of the ICAN Code entitled *Enforcement of Ethical Standards*.
- (c) Compliance with standards and professional development is covered under Statement No. 11 of the ICAN Code captioned *Members in Business*.

This is to assure chartered accountants in business that they have an obligation to carry out their professional work with proper regard for the technical and professional standards expected of them as chartered accountants.

The standards include SASs issued by NASB, IASs and IFRSs issued by the IASC, and where applicable and appropriate, the rules and regulations of SEC and the requirements of CAMA. Furthermore, where they are dealing with banks, the requirements of BOFIA (1991), CON Act (1991) and NDIC Act (1988) and for those working with insurance companies, the requirements of the Insurance Act, 2003 shall be relevant.

An employed member may be faced with a conflict of loyalties in seeking to comply with standards if his employers give contrary directives to him. In any case when an employed member is faced with any ethical problem he may consult the Institute for confidential advice.

Whether the member is solely responsible or not for the preparation and approval of accounting information, he/she should ensure that such information complies with the applicable standards and relevant statutes, rules and regulations. However, if the information does not comply, he/she should ensure that the reasons for non-compliance are stated truthfully, unambiguously and fairly.

- (d) Succession arrangement is properly covered in Statement No. 4 of the ICAN Code captioned *Changes in Professional Appointment*. Some of these are already discussed in Chapter 4. But the emphasis here is on the ethical standards involved.

The incoming auditor or adviser should contact his predecessor for information as to his nomination and appointment. Even if the previous auditor has been a sole practitioner and is now dead, the incoming auditor should try to obtain necessary information as he may need from the latter's alternate (where appropriate), the administrators of the estate or other sources.

If the client does not give his consent for the existing auditor or adviser to discuss the client's affairs with the proposed successor,

the existing auditor should report that fact to the prospective auditor or adviser who should not accept nomination/appointment. The existing auditor or adviser should respond promptly to communication from the prospective auditor or adviser.

When the incoming auditor or adviser asks his predecessor for information as to the clients affairs, lack of which might prejudice the client's interests, such information should be promptly given. There should be no charge for providing such information unless there is a good reason to the contrary such as a significant amount of work having been involved.

### **Note**

When there is no existing auditor or adviser the procedures of succession and the laid down ethical considerations apply equally to the previous auditor or adviser. There are laid down ethical standards guiding a chartered accountant in the course of performing his professional duties, he has to relate with other members of the Institute. The various situations and circumstances under which a chartered accountant may have to relate to another member of the Institute are as follows:

- (a) Joint engagement either as joint auditors, Joint receivers, etc.
- (b) Fresh nomination/appointment calling for communication with predecessors.
- (c) Special assignment which requires expert or specialist advice on certain issues.
- (d) Need for consultancy services, from other members or member firms.
- (e) Other assurance services, for example, involvement in the audit of a company being in the same group either as associate or subsidiary company to other companies having other auditors.

The following terminologies are used in cases of these relationships and they need to be properly understood:

- (a) **Principal Auditors** — these are the auditors with responsibility for reporting on the audit of financial statements of an entity when those financial statements include financial information of one or more components audited by other auditors.
- (b) **Other Auditors** — these are auditors, other than the principal auditors, with responsibility for reporting on the financial information of a component, which is included in the financial

statements audited by the principal auditors. Other auditors include affiliated firms, whether using the same name or not, and correspondent firms, as well as unrelated auditors.

- (c) Incoming Auditors — these are the auditors who are auditing and reporting on the current period's financial statements not having audited and reported on: those for the preceding period.
- (d) Predecessor Auditors — these are the auditors who previously audited and reported on the financial statements of an entity and who have been replaced by the incoming auditors.

### **SELF-ASSESSMENT EXERCISE**

Mention and explain other professional responsibilities you know.

## **3.2 Corporate Governance**

In recent times, the world has witnessed the failure of large corporate organisations which has been attributed to large scale fraud by directors in connivance with auditors. There is the case of Enron in the U.S., Parmalat in Italy and many cases in the U.K. such as Polly Peck, Maxwell Communications and BCCI.

This development brought about once more the debate for corporate governance to be in place which will ensure that companies are well managed by the directors and other management staff to whom shareholders have entrusted this function. Given that in most listed companies, shareholders only have opportunity to find out about the management of the company only at the annual general meetings, which today are often poorly attended. There is, therefore, the need to ensure good corporate governance on the part of the managers of the company as this will not be achieved at annual general meetings.

### **3.2.1 Definition**

Corporate governance is defined as the system by which the affairs of companies are directed and controlled by those charged with the responsibility.

### **SELF-ASSESSMENT EXERCISE**

What is Corporate Governance?

### 3.2.2 The need for Corporate Governance

The failure of large listed corporate organisations described above brought in its wake the lack of public confidence in audit reports and auditing.

It was believed that directors and other management staff who are entrusted with the day to day running of the business enterprise see accounting standards as a set of rules to be circumvented by putting auditors under increasing commercial pressure such that creative accounting becomes the order of the day. The professional accounting bodies dealt with the financial reporting problems by introducing new standard setting regimes for both financial reporting and auditing. However, the general public expressed concern about the accountability of directors in that:

- (a) No clear framework exists to ensure that directors review internal controls in their companies; and
- (b) Accountability for director's remuneration was perceived to be lacking coupled with its inadequate disclosure.

#### SELF-ASSESSMENT EXERCISE

Is there need for Corporate Governance? Justify your position.

### 3.2.3 Corporate Governance Internationally

Internationally, it is organisations such as the UN and the OECD that have been advocating for standards of corporate behaviour. Ministers from all the members of OECD countries, Argentina, Brazil, Chile and Slovakia signed a new international code of conduct dealing with international standards to be followed by multinational companies in combating corruption, safeguarding consumer rights and promoting good labour practices in June 2000 meeting. Responsibility for ensuring that multinational companies operating in or from their home countries abide by the guidelines devolves on each member government.

In the U.K., like Nigeria, corporate governance is dealt with partly in the company's legislation (which specifically requires audit committee) but has generally been developed by independent committees which produced series of reports:

- (a) Cadbury Report
- (b) Greenbury Report
- (c) Hampel Report
- (d) Turnbull Report.

The major reason for setting up the Cadbury Committee was to address the lack of confidence perceived to exist in financial reporting by members of the public and in the ability of auditors to provide the assurances required by users of financial statements.

This stemmed from the relationship between auditors and boards of directors as well as the ability of the board to control their organisations. The Greenbury committee was set up in the light of continuing public disquiet about the excessive amounts that directors are paying themselves in the face of falling company results and the inadequate disclosure of director's remuneration, among other controversies. The committee's recommendations which centred more on director's remuneration were incorporated in the listing requirements of the London Stock Exchange.

It was Hampell committee's report that actually centred on corporate governance and was aimed at restricting the regulatory burden on companies as well as highlighting the positive contribution which corporate governance can make. The London Stock Exchange after considering Hampell Committee's report published the Combined Code. It is generally agreed that in the U.K. and U.S. there is a political will for the improvements in corporate governance backed up with certain amount of statutory authority, but however corporate governance is hinged on self-regulation having been left in the hands of the business world. Shareholders particularly large institutional investors always bring pressure to bear upon companies to improve on corporate governance.

In many European countries there is two-tier board structure consisting of an executive board and a supervisory board, which increases the strength of corporate governance.

### **SELF-ASSESSMENT EXERCISE**

What is the major reason why SEC and CAC inaugurated the Corporate Governance Committee?

#### **3.2.4 Corporate Governance in Nigeria**

Good corporate governance has become an acceptable international practice, which every country is embracing.

Realising the need to align with international best practices the Securities and Exchange Commission (SEC) in collaboration with Corporate Affairs Commission (CAC) inaugurated a seventeen (17) member committee in June 2000. It was headed by Mr. Atedo Peterside,

(OON). The committee was mandated to identify weaknesses in the current corporate governance practises in Nigeria and fashion out necessary changes that would bring about improvements. Membership of the committee was carefully selected to cut across all sectors of the economy including members of professional organisations, the organised private sector and regulatory agencies.

The terms of reference of the committee are to:

- (a) identify weaknesses in the current corporate governance practices in Nigeria with respect to public companies;
- (b) examine practices in other jurisdictions with a view to the adoption of international best practices in corporate governance in Nigeria;
- (c) make recommendations on necessary changes in current practices; and examine any other issue relating to corporate governance in Nigeria.

The committee submitted a draft code of corporate governance on 12<sup>th</sup> July, 2001 which was published in several newspapers and further reviewed at three locations across the country, namely: Lagos, Abuja and Port Harcourt. Comments and contributions were made from various stakeholders of whom a good number of them were accepted and subsequently incorporated in the committee's final report.

The committee's final report which centred on Code of Best Practice on Corporate Governance in Nigeria was approved by the Boards of the Securities and Exchange Commission (SEC), being the regulatory authority of the capital market and the Corporate Affairs Commission, being the regulatory authority of companies in Nigeria. The main target of the code is the Board of directors as leaders of corporate organisations as well as the responsibilities of other stakeholders, including shareholders and professional bodies.

### **SELF-ASSESSMENT EXERCISE**

List any four terms of reference of the corporate governance Committee.

### **3.2.5 Codes of Best Practices on Corporate Governance**

The code is divided into three parts:

- (a) Board of Directors
- (b) Shareholders
- (c) Audit Committee.

**(A) Board of Directors**

This is further divided into the following sub-sections:

**Responsibilities of the Board of Directors**

- (i) The board of directors should be in control of the affairs of the company in lawful and efficient manner, such that the company continuously improve on its value creation.
- (ii) The board should with due regard to the other stakeholder's interest, ensure that the value created is shared among the shareholders and employees.
- (iii) The functions of the board should include but not limited to the following:
  - Strategic planning;
  - Selection, performance appraisal and compensation of senior executives;
  - Succession planning ;
  - Communication with shareholders;
  - Ensuring the integrity of financial controls and reports; and
  - Ensuring that ethical standards are maintained and that the company complies with the laws of Nigeria.

The chairman's primary responsibility is to ensure effective operation of the board and he should as far as possible maintain a distance from the day to day running of the company which should be the primary responsibility of the chief executive officer and management team.

**Composition of the Board of Directors**

- (a) The board should be composed in such a way as to ensure diversity of experience without compromising compatibility, integrity, availability and independence.
- (b) Membership of the board should possess the following attributes:
  - (i) Upright personal characteristics;
  - (ii) Relevant core competencies;
  - (iii) Knowledge on board matters;
  - (iv) Entrepreneurial bias; and
  - (v) Sense of accountability, integrity, commitment to the task of corporate and institutional building.
- (c) The position of the chairman and chief executive officer should ideally be separated and held by different persons.

- (d) There should be a strong non-executive independent director as vice-chairman of the board where the position of the chairman and chief executive officer are combined in one individual.

### **Board of Directors**

- (a) The board should meet regularly, at least once in a quarter, with sufficient notices and a formal schedule of matters specifically reserved for its decision, in order to maintain effective control over the company and monitor the executive and management;
- (b) An agreed procedure should exist for directors to take independent professional advice which the cost should be borne by the company in the furtherance of their duty, if necessary;
- (c) The advice and services of the company secretary who should be appointed by the board and is responsible for ensuring that the procedures are followed and that applicable rules and regulations are complied with, should be accessible to all directors. His removal should be decided by the board; and
- (d) The advice and services of other professionals in areas where such advice will improve the quality of contribution of the directors to the overall decision making process should also be accessible to all directors.

### **Non-Executive Directors**

- (a) Non-executive directors should bring independent judgement to bear on issues such as integrity, performance, resources including key appointments and standard of conduct;
- (b) Shareholders' approval is required where directors' service contract is to exceed three years;
- (c) Other than their fees and allowances, non-executive directors should not be dependent on the company for their income. They should be independent and not be involved in business relationship With the company that could fetter or encumber their independent judgement;
- (d) They should neither participate in the company's share option scheme nor be pensionable by the company;
- (e) Appointment as non-executive director should be for a specified period and re-appointment should be dependent on performance;
- (f) It should be a matter for the entire board to decide the appointment of non-executive directors, which should be done through a defined formal selection process;
- (g) Skills mix of non-executive directors should reflect the range of the competency needs of the company; and

- (h) Proper company and board orientation should be undertaken by newly appointed directors and where necessary formal training aimed at making them effective in the discharge of their duties should be given at the company's cost.

### **Executive Directors**

- (a) There should be full and clear disclosure of directors' total emolument and those of the chairman and highest paid director including pension contributions, stock options, where the earnings are in excess of 500,000; and
- (b) In the determination of their remuneration, executive directors should not play an active role.

### **Compensation of Board Members**

- (a) The remuneration of executive directors should not be fixed at shareholders' meeting, but by the board;
- (b) The remuneration should be recommended by remuneration committees, wholly or mainly composed of non-executive/independent directors and chaired by non-executive director;
- (c) The following should be disclosed in relation to directors' remuneration:
  - (i) Directors' emolument and that of the chairman and highest paid director;
  - (ii) Relevant information about stock options and any pension contribution; and
  - (iii) Future service contract.

### **Reporting and Control**

- (a) It is the duty of the board to present a balanced, reasonable and transparent assessment of the company's position;
- (b) In financial and non-financial reporting, there is an overriding need to promote transparency;
- (c) It is the primary responsibility of the board to ensure good internal controls;
- (d) The board should ensure that an objective and professional relationship is maintained with the external auditors;
- (e) External auditors should not be involved in business relationships with the company;
- (f) An audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties should be established by the board;

- (g) A report on the effectiveness of the company's system of internal control should be presented by the directors in the annual report; and
- (h) In compliance with the Companies and Allied Matters Act, the directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary, with written terms of reference.

## **(B) Shareholders**

### **Shareholders' Right and Privileges**

- (a) The company through the directors should ensure that shareholders' statutory and general rights are protected at all times;
- (b) It should be the responsibility of shareholders to elect directors and approve the terms and conditions of their directorships;
- (c) The venue of the annual general meeting should be carefully chosen such that the majority of shareholders can attend and vote and not be disenfranchised in terms of distance and cost;
- (d) Before the annual general meeting, notices should be sent at least 21 working days with such details as annual reports, audited financial statements and other information that will enable them vote properly on any issue;
- (e) A separate resolution should be proposed by the board at the general meeting on each substantial issue in such a way that they can be voted for in an organised manner;
- (f) The board should ensure that decisions reached at the general meetings are implemented;
- (g) There should be at least one director on the board to represent minority shareholders;
- (h) Unless they are in a competing business or have conflicts of interest that warrant their exclusion, shareholders holding more than 20% of the total issued share capital of the company should have a representative on the board;
- (i) The board should ensure equal treatment of all shareholders such that none is given preferential treatment or superior access to information or other materials; and
- (j) The annual general meeting should be used by the board to communicate with the shareholders and encourage their participation.

### **Institutional Investors**

- (a) Shareholders' activism whether by institutional or by organised shareholders' group should not be discouraged by the board.

- (b) Institutional and non-institutional shareholders with larger holdings should act and influence the standard of corporate governance positively, thereby ensuring the optimisation of stakeholders' value.
- (c) Information made available to institutional shareholders should also be made available to other shareholders at the same time in such a manner as to ensure that neither group enjoys preferential treatment.

### **(C) Audit Committee**

#### **Audit Committees**

- (a) Audit committees should be established by companies with the key objective of raising standard of corporate governance;
- (b) The committee should not be under the influence of any dominant personality on the main board, neither should they get in the way and obstruct executive management;
- (c) They should not act as a barrier between external auditors and the executive directors or encourage the main board to abdicate its responsibilities in reviewing and approving the financial statements; and
- (d) Audit committees should be made up of strong and independent persons.

#### **Composition of the Audit Committee**

- (a) Audit committee should be established in accordance with CAMA Section 359 (3), with not more than one executive director;
- (b) A majority of the non-executives serving on the committee should be independent of the company in terms of management or business or other relationship, which could materially interfere with the exercise of their independent judgement as committee members;
- (c) A non-executive director nominated by members of the audit committee should be the chairman of the committee;
- (d) Membership of the audit committee should be for a fixed tenure; however, any member of the committee should be eligible for re-election after his tenure; and
- (e) The secretary of the audit committee should be the company secretary auditor or such other person nominated by the committee.

### **Qualification and Experience of Members of Audit Committee**

- (a) Members of the audit committee should be capable of reading and understanding basic financial statements and make valuable contributions to the committee's deliberation;
- (b) Audit committee should review not only external auditor's reports but also most importantly the report of the internal auditor;
- (c) Members of the committee should possess the following qualities:
  - (i) Integrity;
  - (ii) Dedication;
  - (iii) Thorough understanding of the business, its products and services;
  - (iv) Reasonable knowledge of the risks facing the company and the essential controls which the company has in place;
  - (v) Inquisitiveness and dependable judgement; and
  - (vi) Ability to offer new or different perspective and constructive suggestions.

### **Terms of Reference for Audit Committee**

- (a) In line with Section 359 (6) (a-e) of the Companies and Allied Matters Act, 2004, the committee should be given terms of reference;
- (b) The performance of the committee and its members should be evaluated periodically and the form of such assessment should be decided by the company; and
- (c) The committee should maintain a constructive dialogue between the external auditors and the board and enhance the credibility of the financial disclosures and the interest of the shareholders.

### **Meetings**

- (a) The number of members of the audit committee would determine the quorum for the meetings and it should be specified in the terms of reference of the committee.
- (b) The committee should meet at least three (3) times in a year.
- (c) The committee should hold a meeting with the external auditors at least once a year without the presence of any executive member.

## **Enforcement and Compliance**

As can be seen from 5.9.3, enforcement of corporate governance is more of self-regulatory effort than statutory backing in the U.K, U.SA and internationally, as large institutional investors brings pressure to bear upon companies to improve on corporate governance. It has generally been argued that in this issue voluntary compliance should be encouraged and where it becomes necessary and applicable, appropriate sanctions should be applied. This is the position adopted by the Securities and Exchange Commission (SEC), and Corporate Affairs Commission (CAC) in the enforcement of compliance with corporate governance code of best practice in Nigeria.

Specifically SEC and CAC will give due consideration to the compliance or otherwise of the provisions of the code in the treatment of issues brought before them.

### **SELF-ASSESSMENT EXERCISE**

Who, according to the code of best practice, should be the chairman of the audit committee?

## **4.0 CONCLUSION**

Having studied this unit, you should be able draw conclusion on the ethical standard required of an accountant and his relationship to fellow members.

## **5.0 SUMMARY**

The unit critically examined ethics vis-a-vis the professional accountant; consequences of unethical behaviour; ethical standards and professional responsibilities of the chartered accountant as well as his/her relationship with fellow members.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Define Corporate Governance.
2. List any two of the terms of reference of the corporate governance committee.
3. Code of Best Practice issued the committee on corporate governance specified the functions of the board of directors. List any two.
4. Who, according to the code of best practice, should be the chairman of the audit committee?

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 3 LOCAL LEGISLATIONS AFFECTING AUDITS**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 The Independent Corrupt Practices and Other Related Offences Commission
  - 3.2 The Economic and Financial Crimes Commission (EFCC)
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing the Independence Corrupt Practices and Other Related Offences Commission and the Economic and Financial Crime Commission.

### **2.0 OBJECTIVES**

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

- State the functions of the Economic and Financial Crimes Commission (EFCC)
- outline the functions of the Independent Corrupt Practices Commission (ICPC)
- explain Audit and Internal Control in Relation to SOx
- describe the effects of SOx on Corporate Governance
- highlight the duties of the Internal Auditor Under SOx
- explain the composition and duties of the Audit Committee Under SOx.

### **3.0 MAIN CONTENT**

#### **3.1 The Independent Corrupt Practices and other Related Offences Commission (ICPC)**

In view of the determination of the Federal Government to fight corruption from all angles and eliminate it from both the private and public sectors, the Corrupt Practices and Other Related Offences Act, 2000 (Anti-Corruption Act) was enacted and the Independent Corrupt Practices and Other Related Offences Commission (ICPC) was established.

The duties of the ICPC, as stipulated in Section 3 of the Anti-Corruption Act are to:

- (a) Receive and investigate any report and prosecute any person where reasonable grounds exist for suspecting that the person has conspired to commit or has attempted to commit or has committed an offence, amounting to corruption;
- (b) Examine the practices, systems and procedures of public bodies and where, in the opinion of the Commission, such practices, systems or procedures facilitate fraud or corruption, to direct and supervise a review of such systems;
- (c) Instruct, advise and assist any officer, agency or parastatals on ways by which fraud or corruption may be eliminated or minimised;
- (d) Advise head of public bodies of any change in practice, System and procedures compatible with the effective discharge of their duties as the Commission deems fit to reduce the likelihood or incidence of bribery, corruption and other related offences;
- (e) Educate the public on bribery, corruption and other related offences; and
- (f) Enlist and foster public support in combating corruption,  
The Anti-Corruption Act has a comprehensive list of offences, which are punishable by imprisonment, fines, and penalties. The offences are summarised as follows:
  - (i) Public officer giving, asking and receiving bribe/gratification;
  - (ii) Public officer inflating the price of any goods or services above the prevailing market or arm's length prices;
  - (iii) Public officer awarding or signing any contract without budget provision, approval or cash backing;
  - (iv) Public officer transferring or spending any sum allocated for a particular project or service to another project or service;
  - (v) Public officer failing to report bribery transaction (Sections 23, 24);
  - (vi) Any person who, with the intention of defrauding or concealing a crime or frustrating the Commission in its investigation, destroys, alters, mutilates, falsifies materials from any book, documents, valuable security, account, computer system, diskette, computer printout or other electronic device of his employer (Section 15); and
  - (vii) Any person, who being an officer charged with the receipt, custody, use or management of any part of the public revenue or property and knowingly furnishes any false statement or return in respect of any money or property received by him (Section 16).

## SELF-ASSESSMENT EXERCISE

What are the duties of ICPC?

### 3.2 The Economic and Financial Crimes Commission (EFCC)

In 2003, the Federal Government established another anti-corruption agency, the Economic and Financial Crimes Commission (EFCC) followed by the enactment of the FCC Act in year 2004. The EFCC is charged with the following responsibilities, among others:

- (a) Enforcement and administration of the EFCC Act in the over-all context of preventing, detecting, investigating and prosecuting all cases of economic and financial crimes in Nigeria;
- (b) Enforcement of the provisions of other laws and regulations relating to economic and financial crimes including:
  - (i) Money laundering Act 1995 (as amended)
  - (ii) Advance Fee Fraud and Other Fraud Related Offences Act 1995
  - (iii) Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Act 1994
  - (iv) Banks and Other Financial Institutions Act 1991 (as amended)
  - (v) Miscellaneous Offences Act 1985:
- (c) Fighting terrorism and terrorist financing.

Section 46 of the EFCC Act defines economic and financial crimes to mean: "the non-violent criminal and illicit activity committed with the objective of earning wealth illegally either individually or in a group or organised manner thereby violating existing legislation governing economic activities of Government and its administration and includes any form of fraud, narcotic drug trafficking, money laundering, embezzlement, bribery looting and any form of corrupt malpractices, illegal arms deal, smuggling, human trafficking and child labour, illegal oil bunkering and illegal mining, tax evasion, foreign exchange malpractice including counterfeiting currency theft of intellectual property and piracy open market abuse, dumping of toxic waste and prohibited goods, etc.

## SELF-ASSESSMENT EXERCISE

Discuss the various responsibilities that EFCC is charged with.

#### **4.0 CONCLUSION**

We have discussed local legislation that was set up to fight corruption in Nigeria. ICPC and EFCC are charged with many duties and responsibilities which will help you as a student to guard against anything that is unbecoming as you climb the ladder in your profession.

#### **5.0 SUMMARY**

We have, in this unit, discussed the efforts of the Federal Government to fight corruption in the public and private sectors of the economy. In that crusade, a look has been taken at the two anti-crime agencies of the Government, Economic and Financial Crimes Commission and the Independent Corrupt Practices Commission, exploring the activities of the two bodies to date.

#### **6.0 TUTOR-MARKED ASSIGNMENT**

1. Mention the offences that are stipulated in the Anti-Corruption Act.

#### **7.0 REFERENCES/FURTHER READING**

- Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.
- ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 4     INTERNATIONAL LEGISLATION AFFECTING AUDITS**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Sarbanes – Oxley Act
    - 3.1.1 Oversight Function of PCAOB
    - 3.1.2 Specific Rules Applicable to the Audit of Corporations
    - 3.1.3 Independence of Public Auditors
    - 3.1.4 Corporate Responsibility for Financial Reports
    - 3.1.5 Improper Influence over the Conduct of Audits
    - 3.1.6 Forfeiture and Penalties Aimed at Corporate Governance
  - 3.2 Auditors and the Risk of Fraud
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, we shall be discussing Sarbanes – Oxley Act and Auditors and the Risk of Fraud.

### **2.0 OBJECTIVES**

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

- discuss the provisions of the Sarbanes Oxley Act (SOx)
- describe audit and internal control in relation to SOx
- explain the effects of Sox on Corporate Governance
- state the duties of the Internal Auditor under SOx
- outline the composition and duties of the Audit Committee under SOx.

### **3.0 MAIN CONTENT**

#### **3.1 Sarbanes-Oxley Act**

The Sarbanes-Oxley Act (SOx), the Public Accounting Reform and Investor Protection Act, was passed and became law in August 2002 in

the US following the series of accounting and governance scandals involving American public corporations, the most widely published being that of Enron and WorldCom corporations which were audited by Arthur Andersen. It took its short name, Sarbanes-Oxley Act (SOx), from the names of the two principal congressional sponsors. The intention was to regulate corporations that are registered under the Securities and Exchange Commission (SEC). The Public Corporations Accounts Oversight Board (PCAOB), was established to ensure adherence to the provisions of the SOx.

The major provisions of that Act relating to accounting and Audit of these corporations are:

- (a) The establishment of a proper internal control system
- (b) Management taking responsibility for the truth and fairness of the financial statements
- (c) At least one member of the audit committee, being a financial expert; and
- (d) Preserving audit working papers for at least seven years.

Other minor provisions of the Act include the requirement for these corporations to establish what is called "whistle blower" programmes. These were to report fraudulent accounting and audit practices anonymously.

Though drafted and approved by the US Congress and designed to apply to corporations registered under the SEC, but by its wording, it has application beyond the US and has now gained worldwide recognition. While the SEC established general guidelines for its application, the PCAOB made specific rules for the application of the guidelines.

The PCAOB is a non-profit making corporation in the U.S. which has oversight responsibilities over all corporations that are registered under the SEC regardless of their size and nationality. The PCAOB is not a professional but a regulatory body with responsibility to oversee the external auditing processes of public corporations. It does not have responsibility for the internal audit processes of these corporations.

However, because of the requirement for corporate governance to establish a proper system of internal control and to take responsibility for the truth and fairness of the financial statements, the activities of the PCAOB impacts directly on the manner in which the internal auditors coordinate their work with the external auditors as part of the overall corporate governance. The PCAOB makes rules for the application of the provisions of the SOx to specific areas as a basis for compliance with the various Auditing Standards that accompanied the SOx.

## SELF-ASSESSMENT EXERCISE

In what cases were the Sarbanes-Oxley Act (SOx) passed in U.S. following accounting and governance scandals?

### 3.1.1 Oversight Functions of the PCAOB

The oversight and regulatory functions of the PCAOB include:

- (a) Registering public accounting firms that handle the audit of public corporations: Details required at registration include:
    - Fees collected from the audit;
    - Audit programmes and quality standards;
    - The details of staff who will be performing the audits; and
    - Any pending criminal, civil or administrative litigations.
  - (b) Establishing auditing standards-most of these standards may not be different from earlier standards issued by the AICPA, but the fact that they are issued by the PCAOB gives a greater weight of law thereby making compliance mandatory;
  - (c) Conduct inspections of registered firms-the quality inspections carried out by the PCAOB may not be different from the peer-group review carried out by the big firms, but the fact that it is carried out by an independent body makes it more credible;
  - (d) Conduct investigations and disciplinary procedures-these investigations may focus on the firm or on particular individuals within the firm. Unethical behaviour may result in sanctions;
  - (e) Performing other standard and quality related functions as the board may decide from time to time-this gives the PCAOB the scope and leverage that it requires in order to ensure that the prescribed audit quality and standards are adhered to; and
  - (f) Enforcing compliance with SOx provisions-SOx has various provisions and it is the function of the PCAOB to enforce compliance as it deems fit.
- The registration record of firms with the PCAOB is a public document open to inspection by corporations at any time.

## SELF-ASSESSMENT EXERCISE

Enumerate the oversight and regulatory functions of the PCAOB.

### 3.1.2 Specific Rules Applicable to the Audit of Corporations

Some of the specific rules as contained in the standards set by the PCAOB that are applicable to the audit of corporations include the

following:

- (a) **Audit paper retention:** Audit working papers relating to the audit of corporations must be retained for a period of time not less than seven years. Apparently this derives from the discovery during the Enron hearings that the firm, Arthur Andersen & Co. had destroyed working papers relating to the audit except for the current year.
- (b) **Concurring partner's approval:** This requires that a second partner, 'either within the same firm or an outside must approve a report before it is issued. Some big firms already have this as part of their hot review procedure, but the difference now is that the concurring partner is also required to sign the report.
- (c) **Scope of internal control testing:** Though it has always been part of normal audit procedure to test the internal control system, but since there is no rule relating to that, the eternal auditor may adopt the most minimal sample for the test. The scope of such test has now increased since the auditors are required to report on their findings following a complete review of the system of internal control.
- (d) **Evaluation of the internal control structure and procedure:** The PCAOB has established models for the evaluation of the system of internal control which requires that external auditors report on their findings relating to identified weaknesses and all cases of material non-compliance. The COSO (Committee on Sponsoring Organisations) model continues to be in use, but the rules-based standards have been replaced by more demanding risk-based standards.
- (e) **Audit quality control standards:** Audit quality standards of the past, were limited to peer-group reviews adopted by big firms, The AICPA is now registered under the ISO 9000 quality standards and firms are required to ensure that they comply with those standards. In practical situations, the external auditors may not meet those standards except with the complementary role of the internal auditor.

The PCAOB has not issued any quality standards of its own but SOx requires that public accounting firms set standards relating to:

- Monitoring of professional ethics and independence;
- Procedures for resolving accounting and auditing disputes within the firm;
- Supervision of audit work;
- Hiring, professional development, and advancement of personnel;
- Standards for the acceptance and continuation of engagements;
- Internal control inspections; and
- Other quality standards as prescribed by the PCAOB.

## SELF-ASSESSMENT EXERCISE

List and explain the specific rules applicable to the audit of corporations.

### 3.1.3 Independence of Public Auditors

To ensure the independence of the external auditors, certain provisions have been put in place such as are contained in section 358 of the Companies and Allied Matters Act, in Nigeria. It was assumed that the external auditors were separate and independent resource persons to the corporation. Gradually, corporations started outsourcing the internal audit functions to the external auditors. This was principally on the consideration of lower costs but also because individuals involved in corporate governance preferred to deal with one body in respect of what they considered essentially the same service. With the Enron scandal coming to the open, it was clear that part of the problem was conflict of interest, as Andersen performed both external and internal audit functions to the corporation. SOx therefore made it illegal for a public accounting firm to provide services both as internal and external auditors. With the separation of functions, other services by public accounting firms to the same corporation as listed below are prohibited:

- (a) Financial information systems design and implementation: Public accounting firms, under SOx rules, are not allowed to design and put in place accounting and financial information system which they are required to evaluate and report upon;
- (b) Bookkeeping and accounting services: It has become illegal for public accounting firms to provide bookkeeping and accounting services to the same corporations where they serve as external auditors;
- (c) Management and human resources functions: Senior audit personnel of the public accounting firms are prohibited from employment in senior accounting positions of the corporations for which they served as external auditors; and
- (d) Other prohibited services: A list of other prohibited services include actuarial, investment advisor, accounting related legal services. This does not include taxation services.

The SOx has a number of other provisions, though they do not have direct impact on the quality of the financial statements nor the auditor's report. Nevertheless, they are part of the requirements designed to bring sanity into the audit processes.

These include the following:

- i. Audit committee's consent prior to any formal approval of all audit and non-audit services;
- ii. External audit lead partner to be rotated at least every five years; Whereas the firms may have had this as its internal arrangement, SOx now makes it a criminal offence where the rotation does not take place as required;

- iii. External auditors to report to the audit committee: Though this had been a requirement even in Nigeria by the provisions of section 359 of (AMA, the external auditor was required to report to the audit committee all management matters in the auditors' report and their disposal by management. This might not have had a significant impact principally as a result of the composition of the audit committee which may not be technically competent to deal with such matters. In the post Enron era and with the position of the audit committee by the provisions of SOx, the external auditor is required to report to the audit committee all alternative accounting treatments adopted by management and the auditor's preferred treatment;
- iv. To assure the independence of the audit committee, only non- executive directors may be appointed members. To be regarded as truly independent, the non-executive director members of the audit committee must not accept any consulting or advisory fees from the corporation as well as from any affiliated subsidiary or associated company; and
- v. The SOx requires that at least one member of the audit committee should be a financial expert in order to ensure that the committee has the expertise to understand the financial statements they are being asked to review.

### **Financial Experts**

Financial expert is defined in the act as a person who through education or experience has:

- Understanding of financial statements and the Generally Accepted Accounting Principles (GAAP);
- Experience in applying such GAAP in connection with accounting as relates to the financial statements of the enterprise;
- Experience in preparing or auditing financial statements that present accounting issues;
- Experience with internal control procedures for financial reporting; and
- Understanding of audit committee functions.

### **SELF-ASSESSMENT EXERCISE**

Who is a financial Expert?

### 3.1.4 Corporate Responsibility for Financial Reports

Though directors had always been required to sign the financial reports of the entity, the signatures had been a matter of fact without substance or personal responsibility. With SOx, the principal financial officers are required to certify the quarterly and annual reports and accounts filed, and accept the responsibility for their truth and fairness. By this, the signatories opine that:

- (a) they had reviewed the report;
  - (b) based on their knowledge, the financial statements do not contain any materially untrue or misleading information;
  - (c) based on their knowledge, the financial statements fairly represent the financial conditions and results of operations of the enterprise;
- a. The directors take responsibility for:
- Establishing and maintaining internal control;
  - Having designed the internal control to ensure that material information about the enterprise and its subsidiaries was made known to the directors during the period when the report was prepared;
  - Having evaluated the enterprise's internal control within 90 days prior to the release of the report;
  - Having presented in the financial statements, the directors' evaluation of the effectiveness of the system of internal control as of the date of the report;
- b. The signing officers had presented to the auditors, audit

#### **Committee and other Directors:**

- All significant deficiencies in the design and operation of internal controls that could affect the reliability of the reported financial data and has, further, disclosed these material control weaknesses to the auditors.
  - Any fraud whether or not material, that involves management or other employees who have significant role in the enterprise's internal control; and
- c. The signing officers have indicated in the report whether there were material controls or other changes that could significantly impact those controls, including corrective actions, subsequent to the date of the internal control evaluation.

### 3.1.5 Improper Influence over the Conduct of Audits

It is possible that management may have genuine disagreement with the auditors. In such situations, the auditor is expected to report same to the audit committee, making clear his preferred position. There are other circumstances where the directors may try to influence the auditors unduly; hence making them accept their position. Some CEOs are rather too powerful, such that the auditor may accept some questionable accounting treatment proposed or adopted by the directors. With SOx, it is now unlawful for any officer or director to take any actions calculated to fraudulently influence, coerce, manipulate or in any way mislead the auditor for the purpose of rendering the financial statements materially misleading. Though, this has always been in Section 368 of CAMA, it has had little force in application. With clear provision in the SOx, the external auditor clearly understands the risk of giving in to management opinion.

#### SELF-ASSESSMENT EXERCISE

What happens when there is an improper influence over the conduct of audits?

### 3.1.6 Forfeiture and Penalties Aimed at Corporate Governance

SOx prescribe various penalties and fines directed at individuals who are in charge of corporate governance. These are designed to enhance the level of compliance with existing rules or introduce new ones to forestall some outrageous behaviour by corporate entity.

These include the following:

- (a) If an enterprise is required by SEC to re-state its earnings owing to material violation of the securities laws, the CEO and CFO will be required to reimburse any bonuses or incentives received on the basis of the original earnings.
- (b) Where someone demonstrates by conduct any unfitness to serve as director, the court is empowered to bar such person acting as director or officer of a corporation.
- (c) Where there are indications of distress in a corporation, SOx prescribes a period of fund black out/ for officers and directors of the corporation. This is based on the fact that officers and directors with inside knowledge may dispose of their stocks in the corporation prior to the final collapse of the entity as was the case in Enron.
- (d) Professional attorneys, who owing to their privileged position have knowledge of material violation of the securities law, are

required to take steps to report such violations to the CEOs for such matters to be put right. Failure to take appropriate steps by the CEO will make the attorney take the matter to the audit committee. The attorney is not however required to take this matter any further owing to the privileged attorney-client relationship.

- (e) Where investors have suffered loss as a result of fraud or improper accounting, and recoveries are made from the fraudulent parties either as a result of administrative or legal action, such recoveries should be paid as financial settlement to the parties who suffered the loss. This is what is referred to as “disgorgement” fund for investors who have suffered loss.

### **SELF-ASSESSMENT EXERCISE**

Outline the various penalties and fines as prescribed by SOx that is directed to those in charge of corporate governance.

### **3.2 The Auditor and the Risk of Fraud**

Prior to accounting scandals, the role of the auditor in relation to fraud may at best be described as ambiguous. It was possible for the auditor to wriggle out of liability for failure to uncover cases of fraud which exist in published financial statements. That was on the basis that no provisions existed in the law that specifically placed the burden of detection of fraud on the auditor. Furthermore sections 331 and 334 of CAMA specifically make it the responsibility of directors to keep proper records and prepare from these records financial statements that show a true and fair view to the members at the AGM.

This position is fast changing as the auditor may not easily get away with the failure to uncover fraud which results in material mis-statements in the financial statements. In the US, apart from the fact that the Statement of Auditing Standards (SAS) 99 requires external auditors to actively perform procedures to detect and correct financial statement fraud, the PCAOB has now issued a new set of rules. Auditing Standards 5 (ASS) specifically directs external auditors to be conscious of the possibility of fraud in the course of their work.

Right from the planning stage through the actual performance of the assignment, the auditor is required to perform entity level fraud risk control assessment. This will include an evaluation whether the enterprise's controls are sufficient to address the identified risks of material mis-statements due to fraud as well as controls intended to address the risks of management override of the controls. Specifically, the evaluation should address the following controls:

- (i) controls over significant, unusual transactions and particularly those that result in late or unusual journal entries;
- (ii) controls over journal entries and adjustments made in the period-end financial reporting process;
- (ii) controls over related party transactions;
- (iii) controls relating to management's significant estimates; and
- (iv) controls that mitigate incentives for, and pressures on management to falsify or inappropriately manage financial results.

The Nigerian Standards on Auditing (NSA) 5 urges the auditor to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatements, whether caused by fraud or error. The statement recognises that it may not be possible for the auditor to obtain absolute assurance that material misstatements in the financial statements will be detected because of the inherent limitation of internal control and because much of the evidence available to the auditor is persuasive rather than conclusive. It therefore directs the auditor to:

- (i) maintain an attitude of professional scepticism throughout the audit;
- (ii) consider the potential for management override of controls; and
- (iii) recognise the fact that audit procedures designed to detect errors may not be effective in the context of an identified risk of material mis-statement due to fraud.

### **SELF-ASSESSMENT EXERCISE**

Differentiate the role of auditor and directors in the management of risk of fraud.

## **4.0 CONCLUSION**

Following the many established cases of accounting scandals, the Sarbanes Oxley Act was passed into law in the United States. Owing to its far-reaching effects, it has been adopted internationally and become operational in many parts of the world, including Nigeria.

The law focuses attention on internal control as a framework for ensuring the reliability of published financial statements. The law makes greater demands on the auditor who in consequence should be conscious of the risk to which he is exposed for failure to detect fraud or errors in financial statements. Company directors now take personal responsibility for the truth and fairness of the financial statements as any acts of impropriety or lack of care may attract-heavy sanctions. Internal auditors now have wider recognition and responsibilities under SOx.

## 5.0 SUMMARY

This unit has discussed the general provisions of the various Acts, audit and internal control in relation to Sox, effects of SOx on corporate governance, duties of the Internal Auditor under SOx and the composition and duties of the Audit Committee under SOx.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. The EFCC is charged with the enforcement of the provisions of other laws relating to economic and financial crimes in Nigeria. Mention any two of the laws.
2. Mention any two specific rules applicable to the audit of corporations?
3. In Corporate Governance, where someone demonstrates by conduct any unfitness to serve as a director, the court is empowered to bar such person from acting as a director or officer of a corporation, True or False?

## 7.0 REFERENCES/FURTHER READING

- Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.
- ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 5      QUALITY CONTROL IN AUDIT AND ASSURANCE REPORTS**

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- 1.0 Introduction
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  - 3.2 Internal Review
    - 3.2.1 Levels of Internal Reviews
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  - 3.4 Hot Review
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

In this unit, effort will be made to explain the various issues that relate to quality control in audit and assurance.

### **2.0 OBJECTIVES**

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

- explain the effects of Nigerian standards on auditing on the quality of audit reports
- discuss the International Standards on Auditing (ISA)
- explain statutory audit reports
- describe audit reviews for quality control purposes.

### **3.0 MAIN CONTENT**

#### **3.1 Review of Audits**

The practice of auditing poses great challenges to the accounting profession. It is a mirror through which the profession is evaluated by the general public. Audit engagements performed to the satisfaction of the client and the public enhance the standing of the firm while shoddy work brings to disrepute not only the firm concerned but the entire

accountancy profession. One aspect of audit procedure that will help guarantee high quality of work is the review process. There may be internal or external reviews. A review may be carried out at various stages of the audit process and by different levels of staff. The overall intention is to ensure that audit work performed at all stages and by different levels of staff meet the required standards of the firm or the accountancy profession at large.

### **SELF-ASSESSMENT EXERCISE**

What do you understand by audit review?

### **3.2 Internal Review**

Internal reviews require that the work performed by one member of staff is subject to thorough scrutiny by a superior audit staff. Hence, this type of review is carried out by various categories of staff in the chain of command concerned with the audit, i.e. supervisors, managers and partners. Audit reviews are, usually, carried out after the completion of the audit work; but before the audit report is signed by the partner.

The review procedure will normally aim at one or more of the following objectives:

- (a) **Internal Control Evaluation** Audit review relating to internal control evaluation aims at determining whether or not the documentation of evaluation was complete. Such documentation will include the flowcharts, the internal control questionnaire (ICQ) and compliance tests. All identified weaknesses should be studied and necessary explanations obtained from client through a management letter.

- (b) **Audit Programme**

The review of audit programmes will confirm whether all aspects of the work have been completed and the result obtained adequately documented. A review of the audit programmes is applicable to both the compliance and substantive tests.

- (c) **Audit Files**-the review of audit files will confirm whether all necessary information has been obtained and all items in the Balance Sheet and Profit and Loss account verified. It will also reveal whether all necessary working papers have been placed in the appropriate sections of the audit files.

- (d) **Accounts**-a view of the accounts will help confirm that they comply with all statutory requirements, the statements of

accounting standards, that appropriate and consistent accounting policies have been adopted and disclosed. This review also confirms that the accounts show a true and fair view.

### **3.2.1 Levels of Internal Reviews**

Internal reviews are classified according to the personnel carrying them out. There may therefore be the supervisor's review, the manager's review and the partner's review. These are briefly discussed, thus:

#### **3.2.1.1 Supervisor's Review**

The supervisor's review is usually carried out on the completed working papers while the audit is still in progress. The supervisor has to take into consideration each step in the audit programme, queries raised and any other additional information obtained.

This level of review will deal more with audit procedures than principles. Typical examples of audit procedures to which the supervisor is likely to focus attention are whether:

- (a) All relevant documents have been obtained and checked for validity and accuracy;
- (b) All procedures in the key control areas have been observed as they are carried out by the client and his staff, such as stock-count and payment of wages;
- (c) The re-computation of significant figures such as provision for doubtful debts or depreciation charge in the financial statements has been carried out to confirm accuracy;
- (d) The cast on schedules obtained from the client has been checked in order to confirm arithmetical accuracy;
- (e) All important procedures which the client had carried out have been re-performed in order to confirm that they were actually carried out and are correct;
- (f) The confirmation of existing evidence provided by the client has been received from third parties such as for debtors and bank balances;
- (g) The design of working papers are in line with the firm's standards;
- (h) The necessary comparisons of current year's balances with prior year's balances have been carried out in order to ascertain the relevant variances; and
- (i) The appropriate indices have been computed and reported for review by a superior officer.

**SELF-ASSESSMENT EXERCISE**

What are the audit procedures supervisors are to focus attention on?

**3.2.1.2 Manager's Review**

The manager's review will usually be done with the use of a checklist to confirm whether:

- (a) The working papers comply with the firm's audit standards;
- (b) The working papers are suitably indexed and cross-referenced;
- (c) All schedules agree with the figures in the accounts;
- (d) All necessary letters of confirmation have been received;
- (e) The letter of representation covers all applicable points;
- (f) The accounts comply with all statutory requirements and the applicable standards of accountancy practice;
- (g) The accounting policies adopted by the client are appropriate, acceptable and consistent with prior years;
- (h) The audit programmes have been duly completed and all audit queries raised during the work have been acknowledged and appropriate responses received;
- (i) The working papers are suitable and adequate or if additional working papers will be required;
- (j) There are any points that put the auditor on enquiry and have to be further dealt with by the appropriate level of authority; whether there are any key points which could lead to a qualified audit report;
- (k) All applicable indices have been ascertained and the effects clearly interpreted on the working papers;
- (l) The various audit evidences obtained are relevant, reliable and sufficient to support the conclusions reached;
- (m) The verification procedures adopted are adequate in the circumstances or if additional procedures will be required for an effective verification work; and
- (n) All indices have been obtained and their implications made known to the partner.

The manager's review as can be appreciated above is a combination of procedures and principles.

**SELF-ASSESSMENT EXERCISE**

Enumerate the procedures that will be carried out in manager's review.

### 3.2.1.3 Partner's Review

This is the last stage of audit internal reviews and is carried out just before the accounts are finalised and signed by the partner. The partner's review is likely to be limited to principles, to the exclusion of procedures. He is likely to look out for those matters which put the auditor on enquiry and which have been separated for his attention. He will like to confirm that all queries raised during the manager's review have been satisfactorily cleared and all matters brought forward from the preceding year's audit have been cleared. By the use of checklist, he is likely to confirm that all matters of accounting principles, related to the audit, have been properly dealt with. Such principles are that:

- (a) Acceptable and consistent accounting principles have been applied;
- (b) Any material departures from the SASs have been appropriately disclosed;
- (c) The presentation and layout of the accounts conform with the firm's standards;
- (d) The letter of representation contains all relevant points;
- (e) All points that put the auditor on enquiry have been brought to his attention;
- (f) The financial statements as they are to be laid before the members show a true and fair view;
- (g) That the audit report is properly worded in line with the opinion expressed; and
- (h) That the accounts have been duly signed by two of the directors.

### SELF-ASSESSMENT EXERCISE

What principles are normally applied in partner's review?

### 3.3 External Reviews (Peer Group Review)

Apart from internal reviews by the supervisor, manager and partner, there may at times be external reviews. This type of review does not take place in respect of only one audit engagement but is designed to ascertain whether the firm's auditing standards conform with those generally acceptable for good audit practice. External reviews are less frequent and are often associated with firms' international affiliations. This type of review is very important if auditing standards are to be maintained and improved. Parties outside the firm are invited, say, once in three years, to confirm that the firm maintains established standards which are consistent with current international standards and those of its affiliations.

### 3.4 Hot Reviews

A procedure of self-examination is referred to as hot review. By this procedure, one manager/partner is specifically designated the quality control reviewer of all audit engagements as soon as the audit is completed and before the report is issued. It is usually carried out soon after the completion of the audit but before the partner's review and issuance of the audit report. It is designed by the firm to ensure that up to the level of the managers, standards set for its audit work are strictly adhered to. Usually the manager/partner engaged in such reviews is one adjudged to be highly skilled, experienced and thorough.

By the use of checklists, the reviewer confirms that:

- (a) Audit files are suitably classified and in line with the firm's practice;
- (b) Working papers are filed in the appropriate sections, suitably indexed and appropriately cross-referenced to the other relevant sections of the audit file;
- (c) The working papers are suitably drawn-up, using standard stationery and format wherever practicable;
- (d) The various lead schedules agree with the related sections of the financial statements;
- (e) Proper procedures have been adopted in the verification work and relevant and sufficient evidence obtained;
- (f) The financial statements show a true and fair view;
- (g) The review points raised at the various levels have been appropriately handled and necessary responses received from the client or the audit staff;
- (h) Appropriate accounting policies have been adopted by the client, that these have been consistently applied and are in agreement with the requirements of the SAS and all departure appropriately disclosed;
- (i) All known or perceived risk areas have been appropriately handled during the audit work;
- (j) All required confirmation has been received;
- (k) The letter of representation has been received and contains all relevant points;
- (l) All points which put the auditor on enquiry have been brought to the attention of the partner and appropriately dealt with;
- (m) All matters brought forward from the previous year's audit have been satisfactorily dealt with in the current year;
- (n) The general procedures adopted are still adequate to meet the firm's standard;
- (o) That resources allocated to the audit are adequate and have been effectively applied;

- (p) The format of the financial statements and the classification of items comply with the statutory requirements; and
- (q) The wording of the audit report is appropriate.

### **SELF-ASSESSMENT EXERCISE**

What use is the use of checklist?

## **4.0 CONCLUSION**

The quality of audit work is paramount in all audit and assurance engagements. The Nigerian Standards on Auditing (NSA) 28 and 29 and the International Standards on Auditing (ISA) expressly state the quality of work expected from a professional audit assignment by the calibre of accountants in public practice

## **5.0 SUMMARY**

The International Financial Reporting Standards (IFRSs) and SAS also state clearly the requirements relating to published financial statements produced by directors for presentation to members. Professional firms have to put in place programmes to ensure that the quality of audit works performed is of the highest standards.

These may include some internal and external reviews carried out at various stages of the audit and by different levels of staff to ensure strict adherence. There are the supervisor's review, manager's review and the partner's review. In addition to these, big firms have external reviews as part of quality assurance process-these are the peer group reviews and 'hot' reviews.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Discuss what you know about Peer review and Hot review

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

**MODULE 4      ASSURANCE REPORT**

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| Unit 1 | Assurance Reports in Audit                                     |
| Unit 2 | Emerging Issues in Audit and Assurance 1                       |
| Unit 3 | Emerging Issues in Audit and Assurance 2                       |
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**UNIT 1      ASSURANCE REPORTS IN AUDIT****CONTENTS**

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**1.0      INTRODUCTION**

In this unit, focus will be on the procedures to writing management letter, different types of reports and how they can be presented.

## **2.0 OBJECTIVES**

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

- explain how to prepare reports for management
- discuss how to prepare report on assurance engagements.

## **3.0 MAIN CONTENT**

### **3.1 Report to Management**

At the conclusion of the internal control evaluation, usually carried out during an interim audit, the weaknesses identified from the internal control evaluation together with the major departure ascertained from the compliance tests, are summarised in an internal control letter to be sent to management. The auditor should also ensure that he brings to the knowledge of management the major weaknesses in the internal control system which will need to be corrected in order to minimise the incidence of fraud and errors in future.

#### **3.1.1 Letter of Weakness**

The evaluation of a system of internal control is a fundamental aspect of any modern audit. It is from this evaluation that the auditor becomes aware of such areas of weakness so as to know whether any errors or fraud have been committed.

The evaluation of the system of internal control and the revelation of errors or fraud is a by-product of a thorough and skill fully conducted audit. It is a way of assisting management by pointing out, the existing weaknesses in the system, their possible effects on the financial statements of the company and a recommendation for improvement. The medium for conveying this important information is the management letter which is also called 'internal control letter' or 'letter of weakness.'

#### **Advantages of Letter of Weakness**

The following advantages may derive from a properly drawn-up and timely letter of weakness:

- (a) It helps to draw the attention of the directors to weaknesses in the internal control system which the auditor uncovered in his examination so that the former can put the matters right.
- (b) It is a medium of calling the attention of the directors to the weaknesses in the system which may occasion loss of assets to the company or lead to incorrect final accounts.

- (c) It helps to call the attention of management to matters which, if not rectified, may give the auditor sufficient grounds to qualify his report.
- (d) It serves as good defence for the auditor in the event of litigation that the weaknesses occasioning the loss sustained by the company were brought to the attention of the directors.

### **SELF-ASSESSMENT EXERCISE**

State the advantages of letter of weakness you know.

#### **3.1.2 Procedure for a Management Letter**

The procedure for writing a good management letter is as follows:

- (a) First, the identified weaknesses should be discussed verbally with the client. This is important since the auditor's understanding of the system may have been faulty owing to misinformation by an uncooperative staff. Prejudice on the part of the auditor can also lead to a faulty conclusion. Furthermore, there may be other compensating controls to take care of an apparent weakness;
- (b) A formal letter should be prepared specifying the areas of weakness, their possible effects and most importantly, recommendation for remedial action;
- (c) A request should be included in the letter for the client's comments and actions intended to correct the identified weaknesses;
- (d) Follow up is very important on the auditor's next visit; and
- (e) Timeliness is of essence for an effective management letter. The letter should be forwarded early enough to allow management sufficient time to take remedial action before the commencement of a final audit.

The evaluation of the system of internal control is carried out during an interim audit, whereas the verification of assets and liabilities takes place at the final audit. It is pertinent to note that a management letter is not the auditor's report. It is not part of the statutory responsibilities of the auditor to send a management letter. It is only a piece of advice to the management as an aid for them to run the business of the company in an orderly manner, safeguard the assets of the company and ensure the reliability of the company's records. It is, as it were, a service to the management as an offshoot of the audit.

### **SELF-ASSESSMENT EXERCISE**

What is the procedure for writing a good management letter?

### 3.1.3 Contents of a Management Letter

A good management letter should contain the following:

- (a) A note of the purpose of the letter;
- (b) A note of the purpose of internal control investigation;
- (c) Disclaimer to the effect that the auditor's examination cannot be relied upon to disclose all weaknesses or fraud that may exist in the system;
- (d) A list of the weaknesses. The explanation has to be specific as to quality and quantity if applicable, and the possible consequences spelt out in detail. Distinction should be made between material and minor weaknesses,
- (e) A recommendation for improvement; and
- (f) A request to management to send a written reply to the points raised and proposed actions to rectify the weaknesses.

### SELF-ASSESSMENT EXERCISE

Outline the contents of a management letter.

### 3.1.4 A Specimen Management Letter

The following is a format for a suitable management letter which the auditor may adopt with the relevant modifications in practice.

A. A. ICAN & Co.  
(Chartered Accountants)  
3 Aiyedire Street  
Surulere, Lagos

October 4, 2007

The Financial Controller  
Study Pack Industries Ltd  
1000 Ikorudu Road  
Lagos

Attention: Mr. J. A. Nyong, FCA

Dear Sir,

MANAGEMENT LETTER  
YEAR ENDING 31<sup>ST</sup> MARCH 20X8

Work has now been completed in respect of the interim audit of your

company for the year ending 31st March 20X8. During our examination, we reviewed the principal controls that your company has established to enable the management, as far as possible, ensure the accuracy and reliability of the records and safeguard the assets.

In addition to reviewing the controls, we also assessed the accounting records as a basis for preparing the financial statements, which, as required by law, show a true and fair view of the financial position of the company. In the course of our examination, some weaknesses in the system of controls came to our notice which, if not rectified, may give rise to incorrect financial statements and/or loss of the company assets. In line with our discussion of 28th September, 20X7, we are writing in order to draw your attention to these weaknesses as revealed by the examinations we carried out.

We set out below those points (not necessarily in the order of significance) which you need to know and our recommendations for the necessary actions for you to put them right.

It must be appreciated that the points outlined below came to our notice during the course of our normal audit procedures. These were designed primarily to enable us to know which aspects of the internal control system we could rely on in the course Of our audit. Hence, it should not be relied upon to reveal all possible weaknesses in the internal control system of your company nor cases of fraud or errors which a more detailed investigation may reveal.

#### Sales in Excess of Credit Limits:

In the course of review we noted four cases of customers who have been allowed to buy goods from the company in excess of their credit limit as follows:

| NAME                        | CREDIT LIMIT | BALANCE | EXCESS |
|-----------------------------|--------------|---------|--------|
|                             | ₦            |         |        |
| APZ Cosmetics Ltd           | 75,000       | 96,750  | 21,750 |
| Glamour Salon               | 30,000       | 45,245  | 15,245 |
| Christy Body Care           | 35,000       | 50,216  | 15,216 |
| Health gate Supermarket Ltd | 125,000      | 157,475 | 32,475 |

#### Effect

It could also give rise to the incidence of bad debt and hence, losses to the company. Although we were told that these were some of the best customers of the company without any risk of default, if this situation is allowed to persist, it may lead to abuse on the part of sales staff.

### Recommendations

We recommend that:

- (a) Credit limits should be strictly enforced
- (b) Follow-up action should be stepped up in order to effect immediate collection of over-due amounts.

### Management Response

#### Suppliers' Accounts not Reconciled:

The system requires that suppliers' statements of account should be reconciled with the balances on the creditors' accounts. We saw two cases where these accounts were not reconciled as at 30th June 20X7.

|                         | STATEMENT | LEDGER  | DIFFERENCE |
|-------------------------|-----------|---------|------------|
| Cram field Chemical Ltd | 578,754   | 674,250 | 95,496     |
| Hardware Packages Ltd   | 802,450   | 984,026 | 181,576    |

#### Effect

If the reconciliation is not carried out, current liabilities may be wrongly stated hence, giving rise to incorrect financial statements.

### Recommendations

We recommend as follows:

- (a) Regular and prompt reconciliation of suppliers' accounts should be carried out;
- (b) This should be reviewed and approved by the chief accountant;
- (c) Disputed amounts should be taken up with the suppliers and necessary corrections effected.

#### Effect

#### Bank Reconciliations not Independently Reviewed:

The system is such that the cashier prepares the bank reconciliation statements and sends same to the chief accountant for approval. Since there is no independent check of the reconciliation, the cashier may exploit this lapse to perpetrate fraud and/or errors and conceal same for a very long time.

### Recommendation

We recommend that the bank reconciliation statement prepared by the cashier should first be reviewed by the accounts supervisor before sending same to the chief Accountant for approval, each signifying his own check by signing.

## MANAGEMENT RESPONSE

### General

The points listed above have been discussed with the chief accountant. We however, look forward to hearing from you, in writing, of the actions you have taken or intend to take to effect an improvement in the system.

Yours faithfully

Chief Examiner

for: A. A. ICAN & Co.

Chartered Accountants

### Points to Note in the Above Management Letter

The points to note in the above management letter are as follows:

- (a) The letter is addressed to the highest level of management where action can be taken;
- (b) The auditor's language is simple and straight to the point;
- (c) Without being in hurry, he outlined the meaning and essence of an interim audit, and explain the procedure he had adopted;
- (d) He did not lay any claims to have done what he did not do. More importantly, nowhere in the letter did he confer the mark of excellence and thoroughness on his job. Rather he pointed out the possible shortcomings of the procedures he had adopted. This is essential since these shortcomings, if eventually uncovered by the client himself, will lead to loss of reputation on the part of the auditor;
- (e) The matters considered on the letter are limited to the important points, which in the opinion of the auditor will affect the truth and fairness of the financial statements;

Furthermore, the auditor tried to create the impression that all the points should be considered on equal merit. Hence, they all deserve equal attention on the part of management;

- (f) The auditor has included the details of his findings in terms of dates and specific amounts involved. Hence he has avoided any general statements;
- (g) In respect of each point raised, the auditor has included a recommendation which is the specific action management should take in order to rectify the reported weakness;
- (h) Before including any matters in the management letter, the auditor had discussed all the points with the Chief Accountant of the company. This is clearly stated in the letter in order not to leave any doubts as to that fact; and
- (i) Finally, the auditor has requested for management responses and feedback from the client about matters raised as well as the planned remedial action. Clearly, this is feasible as the letter was written nearly six months to the year end. It is important that a management letter should be sent early enough to allow management sufficient time to take the required remedial action. This is obvious on the above letter.

### **3.2 Reports on Assurance Assignments**

A report by the auditor is the end product of any audit. In its simplest form, the Companies and Allied Matters Act, 2004 requires the auditor to state in his report whether in his opinion, the accounts:

- (a) show a true and fair view, and
- (b) comply with the requirements of relevant Sections of the Act.

Most auditors' reports are short statements expressing opinions. Hence, an auditor's report is an opinion and not a certificate, although one which is based on sound and logical procedures.

#### **Forming an Opinion on the Financial Statements**

The auditor should evaluate the conclusions drawn from the evidence obtained as the basis for forming an opinion on the financial statements. When forming an opinion on the financial statements, the auditor evaluates whether, based on the evidence obtained, there is reasonable assurance about whether the financial statements taken as a whole are free from material misstatements. This involves concluding whether sufficient and appropriate audit evidence has been obtained to reduce, to an acceptably low level, the risks of material misstatements and evaluating the effects of uncorrected mis-statements identified.

Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, involves evaluating whether the financial statements have been prepared and

presented in accordance with the specific requirements of the applicable legislation for particular classes of transactions, account balances and disclosures.

This evaluation includes considering whether, in the context of the applicable financial reporting framework:

- (a) The accounting policies selected and applied are consistent with the applicable legislation and are appropriate in the circumstances;
- (b) The accounting estimates made by management are reasonable in the circumstances;
- (c) The information presented in the financial statements, including the accounting policies, is relevant, reliable, comparable and understandable; and
- (d) The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements.

Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable legislation also involves evaluating the fair presentation of the financial statements. The auditor considers whether the financial statements, after any adjustments made by management as a result of the audit process, are consistent with the auditor's understanding of the entity and its environment. The auditor considers the overall presentation, structure and content of the financial statements. He also considers whether the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in a manner that gives a true and fair view of or presents fairly, in all material respects, the information conveyed in the published financial statements in the context of the requirements of Companies and Allied Matters Act, Cap. C 20, LFN 2004.

Analytical procedures performed at or near the end of the audit help to corroborate conclusions formed during the audit and assist in arriving at the overall conclusion as to the fair presentation of the financial statements.

### **3.2.1 The Basis and Elements of an Auditor's Report**

The Companies and Allied Matters Act 2004 does not give any clue as to the format of an auditor's report nor the nature of such report, except that it requires that the report should express the auditor's opinion whether the financial statements show a true and fair view. However, the Act provides extensive details (Schedule 6 of CAMA) as to the contents

of the report. On the other hand, the International Standards on Auditing (ISA) and the Nigerian Standards on Auditing (NSA) 28 provide details of the basis and format of an auditor's report.

### **3.3 Elements of the Auditors' Report**

The International Standards on Auditing and NSAs set out the requirements relating to the following elements of the auditor's report when the audit has been conducted in accordance with the standards:

- (a) Title;
- (b) Addressee;
- (c) Introductory paragraph;
- (d) Management's responsibility for the financial statements;
- (e) Auditor's responsibility;
- (f) Auditor's opinion;
- (g) Other reporting responsibilities;
- (h) Auditor's signature;
- (i) Date of the auditor's report; and
- (j) Auditor's address.

#### **Title**

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. A title indicating that the report is that of an independent auditor, for example, "*Independent Auditor's Report*," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

#### **Addressee**

The auditor's report should be addressed as required by the circumstances of the engagement. National laws or regulations often specify to whom the auditor's report on general purpose financial statements should be addressed. Ordinarily, the auditor's report on general purpose financial statements is addressed to those for whom the report is prepared, the shareholders or to those charged with governance of the entity whose financial statements are being audited if it relates to a public sector establishment or enterprise.

#### **Introductory Paragraph**

The introductory paragraph in the auditor's report should identify the entity whose financial statements have been audited and state that the financial statements have been audited.

The introductory paragraph should also:

- (a) Identify the title of each of the financial statements that comprises the complete set of financial statements;
- (b) Refer to the summary of significant accounting policies and other explanatory notes; and
- (c) Specify the date and period covered by the financial statements.

This requirement is ordinarily met by stating that the auditor has worked on the accompanying financial statements of the entity which comprise (state the titles) the complete set of financial statements required by the law, specifying the date and period covered by those financial statements and referring to the summary of significant accounting policies and other explanatory notes. In addition, when the auditor is aware that the financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the financial statements are presented.

This assists readers to identify the financial statements to which the auditor's report relates. The auditor's opinion covers the complete set of financial statements as defined by the Statements of Accounting Standards. In the case of financial statements prepared in accordance with IFRSs, this includes: a balance sheet, an income statement, a statement of changes in equity, a cash flow statement and a summary of significant accounting policies and other explanatory notes. In some circumstances, additional information may be considered to be an integral part of the financial statements.

In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that are not required by law. For example, supplementary information might be presented to enhance a user's understanding of the financial statements or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes. The auditor's opinion may or may not cover the supplementary information and it is therefore important for the auditor to be satisfied that any supplementary information that is not covered by his opinion is clearly differentiated, as discussed below.

In some circumstances, the supplementary information cannot be clearly differentiated from the financial statements because of its nature and how it is presented. Such supplementary information is covered by the auditor's opinion. For example, the auditor's opinion covers notes or supplementary schedules that are cross-referenced from the financial statements.

This would also be the case when the notes to the financial statements

include an explanation of the extent to which the financial statements comply with another financial reporting requirement.

Supplementary information that is presented as an integral part of the financial statements does not need to be specifically referred to in the introductory paragraph of the auditor's report when the reference to the notes in the description of the components of the financial statements in the introductory paragraph is sufficient.

#### Management's Responsibility for the Financial Statements

The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable provisions of CAMA and that this responsibility includes:

- (a) Designing, implementing and maintaining the internal control system relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error:
- (b) Selecting and applying appropriate accounting policies; and
- (c) Making accounting estimates that are reasonable in the circumstances.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable provisions of CAMA. For example, in the case of financial statements prepared in accordance with IFRSs, management is responsible for preparing statements that fairly present the financial position, performance and cash flows of the entity. To fulfil this responsibility, management designs and implements internal control measures to prevent or detect and correct misstatements, whether due to fraud or error, in order to ensure the reliability of the entity's financial reporting. The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable Statements of Accounting Standards.

There may be circumstances when it is appropriate for the auditor to add to the description of management's responsibilities as required above to reflect additional responsibilities that are relevant to the preparation and presentation of the financial statements in the context of the particular case or the nature or the entity; for instance, banks or insurance companies.

The term 'management' has been used in the ISA to describe those

responsible for preparing and fairly presenting the financial statements, i.e., the directors. Other terms may be appropriate depending on the organisation and the legal requirements.

**Auditor's Responsibility** the report should state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. He should therefore, state that his responsibility is to express an opinion on the financial statements based on the audit in order to contrast it to management's responsibility for the preparation and fair presentation of the financial statements.

The auditor's report should state that the audit was conducted in accordance with the Nigerian and International Standards on Auditing. Also, that those standards require that the auditor complies with ethical standards and that he should plan and perform the audit to obtain reasonable assurance, whether the financial statements are free from material mis-statements.

The reference to the standards used conveys to the reader that the audit has been conducted in accordance with established standards. The auditor's report should describe an audit by stating that:

- (a) An audit involves performing procedures to obtain evidence about the amounts and disclosures in the financial statements;
- (b) The procedures selected depend on the auditor's judgment, including the assessment of the risks of material mis-statement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control; and
- (c) An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management as well as the overall presentation of the financial statements.

The report should state that the auditor believes that the audit evidence he has obtained is sufficient and appropriate to provide a basis for his opinion.

### **Auditor's Opinion**

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly in all material respects, in accordance with the requirements of the law. When expressing an unqualified opinion, the opinion paragraph of the auditor's report should state the auditor's opinion that the financial statements give a true and fair view or present fairly in all material respects in accordance with the requirements of CAMA and the SAS. It is important that the auditor should use the appropriate words in expressing his opinion unless in special circumstances or specialised audits where a different wording should be used.

### **Other Matters**

Standards, laws or generally accepted practice in Nigeria may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Such matters may be addressed in a separate paragraph following the auditor's opinion; for instance, compliance with the Central Bank's regulations or the requirements of the Insurance Act 2007.

Other Reporting Responsibilities in Nigeria, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. For example, the auditor was required to report on a company's adherence to provisions of the Productivity, Prices and Income Board's guidelines when that was relevant. Alternatively, the auditor may be asked to perform and report on additional specified procedures or to express an opinion on specific matters, such as the adequacy of the accounting books and records.

### **Auditor's Signature**

The auditor's report should be signed. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both. In addition to the auditor's signature, the auditor is required to declare his professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognised by the law.

### **Date of the Auditor's Report**

The auditor should date the report on the financial statements not earlier than the date on which the auditor has obtained sufficient and appropriate audit evidence on which to base the opinion on the financial

statements. Sufficient appropriate audit evidence should include evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until the auditor obtains evidence that a complete set of financial statements has been prepared and management has accepted responsibility for them.

In Nigeria, the law identifies the directors as being responsible for concluding that a complete set of financial statements has been prepared and specifies the necessary approval process. Hence, the auditor obtains evidence of that approval before dating the report on the financial statements.

### **Auditor's Address**

The report should state the location in the country from where the auditor practices.

## **SELF-ASSESSMENT EXERCISE**

On what is Auditor's report based?

### **3.4 The Auditor's Report**

The auditor's report should be in writing. A written report encompasses both reports issued in hard copy' format and those using an electronic medium. Depending on the conclusions reached on the basis of evidence obtained, the auditor may issue an unqualified or a qualified report.

#### **3.4.1 An Unqualified Report**

The following is an illustration of the auditor's report incorporating the elements set forth above for an audit of financial statements prepared in accordance with the IFRSs for an unqualified opinion in line with the Nigerian Standards on Auditing (NSA) 29. The illustration assumes that the auditor has no other reporting responsibilities required under the Nigerian law.

## **Independent Auditor's Report**

To the Members of ABC Limited  
Report on the Financial Statements for the Year Ended  
December 31, 20X8

We have audited the accompanying financial statements of ABC Company Plc, which comprise the balance sheet as at December 31, 20X8 and the income statement, statement of changes in equity and cash flow statement for the year ended, a summary of significant accounting policies and other explanatory notes.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material mis-statement, whether due to fraud or error; selecting and applying appropriate accounting policies and making accounting estimates that are reasonable in the circumstances.

### **Auditor's Responsibility**

Our responsibility is to express an Opinion on these financial statements based on our audit. We conducted our audit in accordance With International Standards on Auditing and NSA. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence which we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## Opinion

In our opinion, the financial statements give a true and fair view of (or “present fairly, in all material respects,”)the financial position of the company as of December 31, 20X8, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards and SASs.

Date of the auditor’s report  
Auditor’s address

Auditor’s Identity  
Auditor’s Signature

The above is a standard report which has been worded in its simple form. If the financial statements contain any assets which have been revalued, then the report will include the phrase "including the revaluation of certain assets" after the words international Financial Reporting Standards and SASs. The above is the standard wording of an unqualified report. It may however be modified as the auditor thinks fit.

## SELF-ASSESSMENT EXERCISE

What are the types of auditor’s report?

### 3.5 Contents of the Auditor's Report

The Act requires the auditor's report to include specific statements to the effect that:

- (a) Proper books of accounts have been kept;
- (b) Proper returns have been received from branches not visited by the auditor.
- (c) The financial statements are in agreement with the books and returns;
- (d) All information and explanations necessary for the audit have been obtained. The financial statements show a true and fair view; and
- (e) The financial statements comply with the relevant statutes and other pronouncements.

If the auditor's report is silent on any other matters not mentioned above, it is assumed that he is satisfied and in agreement to such matters.

### 3.6 Modifications in the Auditor's Report

The Nigerian Standards on Auditing (NSA) 29 describes certain circumstances when there may be modifications in the auditor's report in matters that do not affect his opinion. In such circumstances, it is

possible for the auditor to draw attention to some matters in the financial statements without qualifying his report. This is only a matter of emphasis. For instance, where the financial statements contain exceptional or unusual items of income or expenditure such as premium in special insurance cover for unusual risk or losses on such unusual risk, the auditor may wish to draw attention to this.

Another example where an auditor may wish to draw attention to significant matters in the financial statements without qualifying his report is a situation where a company that has a record of making profit, ends up with a loss in a particular year. It will be necessary for the auditor to draw the attention of readers to the cause of the loss. The intention of the auditor, in this instance, is to call the attention of readers to this unusual occurrence, indicating the item of cost or expenditure occasioning the loss and not to qualify his report.

The need on the part of the auditor to draw attention to an unusual item of cost or expenditure will be compelling if it has had the effect of changing what would have been a profit into a loss or an unusual gain changing what would have been a loss into a profit. In both cases, this does not amount to a qualification.

For instance, where the loss occurred as a result of a catastrophe such as fire which destroys a significant portion of the inventory, thus changing what would have been a profit into a loss, then there is need for the auditor to make reference to this in his report and this will not amount to a qualification.

Where however, the auditor is of the opinion that there has been incomplete or improper disclosure of an item in the financial statements, he may expand the item in his report as is proper. This amounts to a qualification in addition drawing the attention of readers to the particular item. For instance, where an item of income or expenditure relating to a prior year has been included in the current year without an indication that it does not relate to the current year, the auditor should make the appropriate disclosure. This amounts to a qualification because without the disclosure the financial statements will not give a true and fair view.

Another example is where surpluses arising from the revaluation of fixed assets are included in the profit and loss account when the related assets have not yet been disposed, hence inflating the profit or changing a loss into a profit. The auditor has the obligation to disclose this in his report. This will amount to a qualification as well as drawing the attention of readers to this departure from generally accepted principle of accounting.

The wording of an unqualified audit report may be changed appropriately to suit the particular circumstances but the basic requirements of the Companies and Allied Matters Act must be satisfied. It is possible that a set of financial statements could be prepared under some principles which amount to a departure from a statement of accounting standard. With this departure, the financial statements can still show a true and fair view. In that case, it is important that the auditor makes a specific reference to the departure. This does not amount to a qualification but is aimed at avoiding the readers being misled and to ensure that their attention is drawn to the departure or any other matters which may require emphasis.

### **SELF-ASSESSMENT EXERCISE**

What brought about modifications in auditor's report?

### **3.7 Qualified Auditor's Report**

There are other matters which affect the auditor's opinion and in material circumstances where he is unable to express an unqualified opinion and which may lead to a qualified auditor's report. These are situations where:

- (i) there is a limitation on the scope of the auditor's work or
- (ii) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statements' disclosures.

These circumstances are discussed in the Nigerian Standards on Auditing (NSA) 29 - Modifications to the Independent Auditor's Report. It is the duty of the directors to keep proper records of a company's transactions and prepare the financial statements. It is the duty of the auditor to examine these financial statements and report thereon.

If the auditor is not satisfied with any matter related to the financial statements, he has a right to deal with that matter in his report, thereby making his dissatisfaction known to the shareholders. The auditor does not have a right to insist on having the system of book-keeping or the financial statements themselves altered, but if it is so bad that these financial statements fail to give a true and fair view, he must make a report to that effect to the shareholders.

When the auditor has decided to make reservations in his report, the choice of words will be very important to convey his views to the readers. The auditor should never allow pressure to be brought upon him

as to the exact words to use in his qualification. This is where his right of independence is of utmost importance.

The Act does not lay any specific requirements as to the manner of qualification of an audit report, but the guiding principle is that the qualifying statement has to be direct, informative and unambiguous.

It should be clearly worded as to leave no doubt in the minds of readers as to the meaning and implication of the qualification on the financial statements.

**(a) Points to Note in a Qualification**

In issuing a qualified report the auditor should note the following guidelines:

- (i) The qualification should be concise, to the extent that it does not impair clarity;
- (ii) It should be specific as to the items and facts and as far as possible the amount involved;
- (iii) Based on the available information, it should make clear the effect on the financial statements; and
- (iv) It should express the auditor's opinion without being misunderstood.

**(b) Grounds for a Qualification**

Qualifications in the auditor's report can arise on two principal grounds. These are 'uncertainty' and 'disagreement.'

**Uncertainty**

There may be some matters relating to the financial statements of a company which are uncertain as at the date of the balance sheet and which make it difficult for the auditor to form a valid opinion as to their effects on the financial statements or the amount at which they are stated. Examples of these are:

- (i) Major litigations involving the company;
- (ii) The final outcome of major contracts;
- (iii) The recoverability of debts;
- (iv) The continued existence of the company as a going concern; and
- (v) The recoverable value of damaged or obsolete stocks.

Since matters relating to the above may result in many different

possibilities, the auditor is not able to form an opinion as to the final outcome; hence, the amounts at which they are shown on the financial statements. For instance, for a company that is engaged in litigation, the decision of the court may make the company liable or not liable. Even when liable, the liability may be for a higher or lower amount than anticipated. A debtor, in respect of whom provision has been made, may pay in full or pay less than the amount that was anticipated. Hence at the point when the auditor issues his report, he is not sure of the final outcome; therefore, the opinion expressed is based on an uncertain situation.

### **Disagreement**

This arises in situations where the auditor has been able to form an opinion, but this is in conflict with the opinion of the directors. Examples of these are:

- (a) departures from generally accepted accounting principles;
- (b) incomplete disclosure of matters in the financial statements,
- (c) disagreement of amounts in the financial statements;
- (d) inappropriate classifications and presentation of items in the financial statements; and
- (e) non-compliance with statutory requirements.

Based on their understanding or perception of a situation and its effects on the financial statements, the directors may depart from a particular accounting principle, make what they consider to be the appropriate disclosure of the departure or make a re-classification of the items in the financial statements. The auditor may have a different opinion of such departure, re-classification or disclosure and hence may qualify his report.

### **(c) What Type of Qualification to Issue**

On each of the two grounds, uncertainty and disagreement, the auditor has a number of options as to the kind of qualification to issue depending on whether the matter under consideration is fundamental and if the effect is material or otherwise.

In cases of uncertainty he can give either:

- (i) a "disclaimer of opinion" if the matter is fundamental. This shows that the auditor has not been able to form an opinion as to whether the financial statements give a true

- and fair view.
- (ii) a "subject to opinion" qualification if the matter is material but not fundamental. This shows that the financial statements give a true and fair view only if the portion of the financial statements referred to is correct.

In cases of disagreement, the auditor can give:

- (a) an "adverse opinion" if the matter under consideration is fundamental. This is to the effect that the financial statements do not give a true and fair view.
- (b) an "except for opinion" report if the matter is material but not fundamental. This is to the effect that the financial statements give a true and fair view except for matter referred to.

The circumstances under which an auditor may issue exception reports include the following:

- (i) If proper accounting records have not been kept;
- (ii) If proper returns have not been received from branches not visited by them;
- (iii) If the financial statements are not in agreement with the records and returns;
- (iv) If they have failed to obtain information and explanations necessary for the audit; and,
- (v) If the information given in the directors' report are inconsistent with the financial statements.

It will be necessary to consider each of the above circumstances under which an auditor may issue an exception report and explain how the financial statements can show a true and fair view in spite of an exception pointed out in the report.

- (i) Where proper accounting records have not been kept, as may be the case in many practical situations, the auditor may be able to get the directors to re-submit the financial statements as is appropriate; he will then be able to issue a report to the effect that the financial statements show a true and fair view, except that the records (in whatever respects) have not been properly kept.
- (ii) Where proper returns have not been received from branches, it is possible for the directors to provide explanations such that the financial statements are adjusted to the satisfaction of the auditor. In that case, he is able to issue a report to the effect that the financial statements show a true and fair view except that proper returns were not received from the affected branches.

- (iii) When the financial statements are not in agreement with the records, the overriding need on the part of the auditor is to ensure that they show a true and fair view. This is fundamental and hence of greater significance than the same financial statements being in agreement with the records. In situations such as this, the auditor will be able to issue a report to the effect that the financial statements show a true and fair view, except that they are not in agreement with the records;
- (iv) There may be certain matters relating to the financial statements which the directors may not be able to explain to the satisfaction of the auditor. In such a situation, the auditor may issue a report to the effect that the financial statements show a true and fair view, except for the matter (specifically mentioned) which has not been properly explained by the directors; and
- (v) Where any information contained in the directors' report is inconsistent with the financial statements, it is possible for the auditor to issue a report to the effect that the financial statements show a true and fair view, except that the particular matter in the directors' report is not consistent with the financial statements.

### **3.8 Materiality**

Auditors are reluctant to qualify reports and usually will not do so on trivial matters. It is therefore, important to consider in all cases when a qualification is contemplated whether or not the matter under consideration is material or not.

Materiality is a particularly difficult matter in practice and also of great importance. It is always tempting to avoid the need to qualify a report by convincing oneself that the matter is not material. Caution should therefore be exercised before coming to the conclusion on matters of materiality.

The following considerations are helpful in deciding on materiality:

#### **(a) The Companies and Allied Matters Act**

If the law requires any items to be disclosed, then such a disclosure must be made for the financial statements to comply with the requirements. The amount of such an item ceases to be of any significance. For instance, the law requires that in the balance sheet, current assets should be shown separately from fixed assets. This requirement should be complied with regardless of the amount involved.



**(b) Fundamental Principles of Accounting**

Certain matters touch directly on fundamental principles of accounting. Such fundamental principles may consist of aggregating, classifying and presenting of accounting information. This is purely an area of professional judgment and all matters that are in conflict with fundamental principles of accounting have to be disclosed, e.g., the inclusion of prior year profits/losses in the current revenue. The classification of fixed assets and current assets under one heading or the capitalisation of revenue expenses which ordinarily should have been expensed, as in the widely publicised case of WorldCom, is fundamental to accounting and hence is material at all times.

**(c) Absolute/Relative Amounts**

Generally the materiality of an item is not entirely dependent on the size, but the size of any item in relation to other items in the balance sheet is a much better guide. For instance, a bad debt of 100,000 may not be material where total debts amount to ₦1,000,000, whereas a bad debt of ₦10,000 may become critical where total debts amount to only ₦50,000. In this case, the consideration of materiality will involve a decision as to whether the bad debt should be disclosed as a separate item or as a part of a large expense classification. Where bad debts occur it might be disclosed as a matter of special emphasis by showing its effect on the overall performance.

**(d) Timing**

The point in time at which an event took place may also help to determine the materiality of an item. For instance, if an event occasioning a loss to a company takes place subsequent to the balance sheet date, it may not be disclosed unless its effects on the published accounts are significant such that the accounts would have otherwise been a profit but for the occurrence of the post balance sheet event.

**How to Assess an Item for Materiality**

To assess an item for materiality, the following should be considered:

- (a) Compare the magnitude of the item with the overall view presented by the financial statements;
- (b) Compare the magnitude of the item with that of the previous years;
- (c) Compare the size of the item with the magnitude of the total of which it forms a part;
- (d) Consider the context and presentation of the item, whether it affects the true and fair view of the accounts;

- (e) Statutory implications are very important; and
  - (f) Some items are always material because of their nature being required by law to be disclosed, e.g., directors' remuneration.
- Overall Considerations for Qualifications Issues to be considered are:
- (i) The degree of approximation of an item will affect the materiality of error. For example, an error in depreciation may be immaterial while errors in directors' fees may be material;
  - (ii) In the years when the profit is low an error which will change the profit into a loss is material, no matter the size;
  - (iii) And some items may have significance that is disproportionate to the size, e.g. income from investment.

### **When is a Qualification Necessary?**

The need to qualify may arise in the following circumstances:

- (a) The auditor is unable to obtain all the information and explanations necessary for the purposes of the audit. Examples are where:
  - (i) He is unable to verify title, value or existence of assets.
  - (ii) He is unable to verify the amount of a liability.
  - (iii) He is not satisfied that all existing liabilities have been included.
- (b) The auditor is unable to satisfy himself that:
  - (i) Proper books of accounts have been kept.
  - (ii) Proper returns have been received.
  - (iii) The financial statements agree with the books and returns.
- (c) The financial statements do not give a true and fair view.
- (d) They do not comply with the requirements of CAMA.
- (e) The policies adopted are inappropriate or inconsistent.
- (f) There is a departure from a statement of accounting standard, without the appropriate disclosure.

## Deciding Finally to Qualify the Report

Before the auditor finally decides to qualify his report, he should resolve the following questions:

- (a) On what specific matter does he have reservations and what is the monetary amount involved?

It is essential for the auditor to have perfect understanding of the matter in respect of which he is not satisfied and hence the ground for his qualification. Only then will the auditor be able to appropriately express himself in his report without the risk of being misunderstood.

- (b) Does he disagree with the presentation or the information made available to him?

If the auditor disagrees with the presentation of the financial statements or the information made available to him by the directors, he should have alternative presentation format or alternative information.

- (c) Is the matter involved material?

The matter in respect of which the auditor is qualifying his report should pass the materiality test as specified above. A qualification should never be in respect of trivial matters.

- (d) Can he persuade the directors to re-submit the financial statements in order to satisfy him?

Where the directors can be persuaded to modify the financial statements to satisfy the auditor, the qualification is no longer necessary.

- (e) If he lacks information, is it possible for him to get more information by carrying out additional examination?

The auditor should never qualify his report on grounds of uncertainty (it is still possible to obtain additional information even if it is by adopting alternative procedure). The need to qualify his report will not arise if the auditor is unable to provide answers to any of the matters above. For instance, the need for a qualification will not arise if the auditor cannot determine the specific matter in respect of which he is not satisfied, since his qualifying statement ought to clearly state the matter in respect of which he is expressing reservations. Similarly, if he can persuade the directors to modify the financial statements to satisfy him, then there is no point for a qualification.

Furthermore, the auditor will bring himself to disrepute, if he issues a qualified report in respect of a matter where he lacks the information he could have obtained by carrying out additional or alternative procedure.

## SELF-ASSESSMENT EXERCISE

Mention the two principal grounds on which an auditor may issue a qualified report.

### 3.9 Going Concern Assumptions

Perhaps, one factor that may lead to modifications in the auditor's report is in relation to the 'going concern' principle. If the use of the going concern assumption is appropriate but a material uncertainty exists, the auditor considers whether the financial statements:

- (a) Adequately describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions; and
- (b) State clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify his report by adding an emphasis on the matter that highlights the existence of a material uncertainty relating to the event or condition which may cast significant doubt on the entity's ability to continue as a going concern, and draws attention to the note in the financial statements that discloses the relevant matters.

In evaluating the adequacy of the financial statement disclosure, the auditor considers whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue, realising its assets and discharging its liabilities in the normal course of business.

The following is an example of the relevant paragraphs when a qualified opinion is to be expressed:

"The company's financing arrangements expired and amounts outstanding are payable on March 19, 2018. The company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge

its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. In our opinion, except for the omission of the information included in the paragraph above, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the company at December 31, 202(7 and its operating performance and its cash flows for the year then ended in accordance with the Companies and Allied Matters Act".

The following is an example of the relevant paragraph when an adverse opinion is to be expressed:

"The company's financing arrangements expired and the amount outstanding was payable on December 31, 202(8. The company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern, and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business.

The financial statements (and notes thereto) do not disclose this fact. In our opinion, because of the omission of the information mentioned above, the financial statements do not give a true and fair view of (or do not present fairly) the financial position of the company as at December 31, 202(8, and its operating performance and its cash flows for the year then ended in accordance with (or do not comply with) the Companies and Allied Matters Act."

#### **4.0 CONCLUSION**

We have discussed in this unit what management report is all about, the procedure to writing management letter, what can lead to issuing of qualified and unqualified report.

#### **5.0 SUMMARY**

The auditor may report to management those matters relating to weaknesses in internal control which come to his notice in the course of his evaluation of the system. This is part of his effort to help management to ensure the accuracy and reliability of the records, run the business in an orderly manner and safeguard the assets. The statutory responsibility of the auditor, however, is to report to the members. This is the report under the assurance engagement. The auditor may issue an unqualified report where he is satisfied that there are no matters relating to his examination of the financial statements which he needs to bring to the notice of the members. NSA 29 requires, if need be, to modify his report, and as is appropriate, for emphasis of matter in order to draw

attention to specific items in the financial statements. Where, however, the auditor is unable to issue an unqualified report because there are matters that affect his opinion, he is required to issue a qualified report.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Itemise the elements of auditor's report.
2. Mention any two types of qualified report.
3. Mention any two types of qualified audit report.
4. List two elements of a standard auditor's report.

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 2      EMERGING ISSUES IN AUDIT AND ASSURANCE 1**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Transnational Audits
  - 3.2 Local Standards in Relation to Transnational Audits
  - 3.3 The Loss of Credibility in Financial Reporting
  - 3.4 Business Failure in Relation to Reporting Failure
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

A country, as a reporting jurisdiction, may set for itself high standard of accounting and audit practice. Such standards are expected to cover the local needs of entities within the country. This unit will be dwelling on that and also how stake holders have lost credibility in financial report presented.

### **2.0 OBJECTIVES**

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

- explain transnational audits
- discuss local standards in relation to transnational audits
- describe the loss of credibility in financial reporting
- discuss business failure in relation to reporting failure.

### **3.0 MAIN CONTENT**

#### **3.1 Transnational Audits**

The present reality is that countries are connected so closely in an increasingly global economy. The best standards and processes are therefore collaborative efforts that take into consideration worldwide international needs and requirements. The International Standards Organisation (ISO) sets standards which cover a wide range of areas, including even the most informal areas of personal services. These cover those areas which are necessary for governance and enterprise quality

services which include auditing. These are covered by standards issued by the International Auditing and Assurance Standards Board (IAASB), a special arm of the International Federation of Accountants (IFAC). With the issue of any international standard, enterprises are expected to take steps to comply with the standards but it will require outside "auditors" to certify the compliance.

Compliance with International Standards on Auditing (ISA) which relate to transnational audits is expected to be at a higher level than the general ISO standards. This is so because of the following reasons:

- (a) The credibility of financial reporting is both a national and an international issue, with actions required at both levels. Although the framework within which companies operate is still primarily national or home based, international action is necessary as the changes made at the national level are to produce both improved and more consistent practices.
- (b) Secondly, to improve the credibility of financial reporting, action will be necessary at all points along the information supply chain that delivers financial reporting to the market. Corporate management and boards of directors, that have the prime responsibility for financial reporting as well as auditors, standard setters, regulators and other participants in the reporting process such as lawyers, investment bankers, analysts and credit-rating agencies, all have important roles to play and improvements in practices to make in order to restore the credibility of financial reporting.
- (c) Thirdly, integrity, both individual and institutional, is essential as the absence of sterling quality has been a major contributor to the financial scandals and corporate failures of recent years whose effects cut across national boundaries.

Transnational audits are particularly relevant in relation to large firms of auditors. These firms are multi-national, but organised differently from their large clients, the multi-national corporations. They are networks of independent firms with common processes and basic policies and standards, but without common or central regulatory rules. Each independent firm is subject to national laws and professional regulations in the country in which it operates. The firms share certain central costs.

When performing an audit work for a multi-national corporation, the headquarters office will assign a team and issue instructions such that work can be performed in line with the requirements of the client's home country. As a result, a large firm's name is associated with financial reports presented, using a wide variety of national standards; if these reports comply with the relevant national standards they will all receive

"clean" opinions. This will continue to be the case until one set of accounting standards is widely accepted.

### **SELF-ASSESSMENT EXERCISE**

What is the relevance of International Standard on Audits (ISO)?

### **3.2 Local Standards in Relation to Transnational Audits**

Every country has its auditing standards for the reporting jurisdiction. In Nigeria, there is the Nigerian Standards on Auditing (NSA) issued by the Nigerian Auditing Standards Committee (NASC), a special committee of the Institute of Chartered Accountants of Nigeria (ICAN). To date, the committee has issued a total of 32 NSAs, on a variety of topics, ranging from "Objective and General Principles Governing an Audit of Financial Statements", issued in July, 2006 to "The Independent Auditor's Report on Special Purpose Audit Engagements", issued in December, 2008. The objectives of these standards are to provide an understanding of the basic principles of auditing and the guidelines for their application to specific situations. In doing this, the Nigerian Accounting Standards Board (NASB) takes into consideration the pronouncements of the relevant International Standards on Auditing (ISA) issued by the International Federation of Accountants (IFAC) of which ICAN is a member. Where the guideline of an ISA is significantly at variance with the applicable law in Nigeria, the council of ICAN is expected to issue additional explanatory foreword to provide guidance on such differences.

Apart from the questions of adequacy of standards in individual countries, there are significant variations among reporting entities, leading to confusion and difficulty in comparing financial statements between countries. With investments across national boundaries now commonplace, this development increases the difficulty of making informed investment decisions as well as creating problems for preparers who have to apply more than one set of standards.

The difficulties at the national level may arise because:

- (a) individual standards are weak
- (b) they may be poorly grounded in principles
- (c) they may fail to consider assets such as intangibles; or
- (d) they may have inadequate emphasis on forward-looking information or on risks.

Further factors that contribute to the weaknesses of local auditing standards may include:

- (a) standard setters being subject to political pressures
- (b) having inadequate resources
- (c) having sources of finance which raise questions about their independence; and
- (d) begin sufficiently timely in responding to market needs.

These weaknesses in local auditing standards have lead to weak or faulty financial reporting which in itself may be the major cause of corporate failure. In parallel with this, there has been great concern, ill some cases outrage on the part of investors, regarding the "fairness" of the operation of a market system. These are in situations where shareholders have lost their investments, and employees and pensioners have lost their jobs and pensions, while those running the companies and seen as responsible for those losses, have enriched themselves even as their businesses collapsed. The scale of this issue is evidenced in the U.S. by a calculation that executives of 25 companies whose stock prices fell by 75% or more between January 1999 and May 2002, many of which had both business and reporting problems, "walked away" with \$23 billion (Fortune, September 2, 2002, page 64). Similar concerns about the level and terms of corporate compensation, even if involving smaller numbers, have arisen in other countries. These concerns have reduced the credibility of all those involved in the process of providing financial and other information.

### **SELF-ASSESSMENT EXERCISE**

What factors contributed to the weakness in Local Standard on Audit?

### **3.3 The Loss of Credibility in Financial Reporting**

Failures of businesses in which deficiencies of financial reporting and corporate disclosure have figured prominently are not new phenomena. However, high profile cases of the recent past, such as Enron, WorldCom, Global Crossing, Adelphia Communications, HIH, Tyco, and Vivendi and most recently, Royal A hold and HealthSouth, together with a host of smaller-scale examples worldwide such as Cadbury in Nigeria, have drawn far greater attention to this area. At the same time, there has been evidence of an increased frequency of re-stated financial statements. All these have had a negative and cumulative impact on the way informed opinion views the quality of financial reporting. This loss of credibility has been widespread across capital markets. Problems in one industry have been contagious, impacting other industries with similar negative characteristics. The increasingly global nature of the

markets and businesses has resulted in concerns crossing national boundaries.

A key factor in the scale of the problems was the unprecedented high level of share prices in many markets. Maintaining these price levels was a top management objective and when it became clear that the supposed level and trend of profitability justifying the levels had not existed, the fall in share prices was accentuated by a major re-rating of the shares. This then impacted share prices in similar companies.

Financial statements have historically been one of the main ways in which information has been provided by a company to its shareholders and investors considering whether to contribute capital. Reduced confidence in financial information and corporate disclosure produces an investor retreat and results in an increased cost of capital. This reduces the economy's productivity.

### **SELF-ASSESSMENT EXERCISE**

Narrate why there is loss of credibility in financial reporting and proffer solution.

### **3.4 Business Failure in Relation to Reporting Failure**

Almost all the high profile failures are the result of the combined effect of failures in business, governance and reporting. The business issue that should be communicated to users of the financial statements if not properly disclosed, governance structures will fail to prevent or detect 'this; hence, a reporting failure results. As an entity moves closer to business failure, the incentive to distort reporting increases and, therefore, the chance of reporting failure increases. A reporting failure on its own will rarely cause a business failure but can allow poor business practice to be extended and delay the confronting of difficult business decisions. However, there appears to be a close linkage between business failure and faulty reporting such that many examples of misreporting, particularly when large sums are involved, appear to be part of the management policies that produced the business problem.

The close relationship between business failure and reporting failure means that the issue of governance generally is closely linked with reporting failure. However, business failure is an inherent and inevitable feature of a market economy. Alternatively put, strengthened governance and reporting practices, and the improved credibility of financial information that should result, will not eliminate business failure, although any improvement should reduce the chances of failure arising from deception or lack of transparency.

## **4.0 CONCLUSION**

In this unit, you have learnt that the prevalence of fraud in organisations is very disturbing. Frequent cases of restatement of financial statements have brought about collapse of big companies. Some of the reasons were due to weaknesses in local standards that now led to the introduction of the international standards. The internal auditors should be alive to their responsibilities.

## **5.0 SUMMARY**

Recent cases of failure in financial reporting led to the loss of credibility in financial reporting and the audit processes. These reporting failures were interpreted as being partly responsible for the failure of large corporations with disastrous consequences. The recent failure of such large corporations which were seen as safe and stable has caused regulatory authorities, standard setters and governments to issue rules and regulations, which may not be entirely new but which at least reinforced existing rules for corporate governance and auditors. These rules are applicable to all corporate entities but they are particularly relevant to corporations, whose activities transcend national boundaries, thus placing greater burden on the auditors of such corporations.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Explain what you understand as business failure in relation to reporting failure.
2. What is the loss of credibility in financial reporting?

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

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## **UNIT 3      EMERGING ISSUES IN AUDIT AND ASSURANCE 2**

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### **1.0 INTRODUCTION**

There has been a lengthy history of corporate failure linked to governance and reporting failure. The recent high profile corporate failures may have involved larger numbers, but many of the issues highlighted are similar to those raised by cases in past periods. The cumulative impact of high profile cases has led to a steady loss in the credibility of financial statements and the participants involved with producing and reporting on them. This will be the focus of study in this unit.

## 2.0 OBJECTIVES

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

- explain the origins of loss of credibility
- discuss the global nature of the loss
- explain social and environmental audits.

## 3.0 MAIN CONTENT

### 3.1 The Origins of Loss of Credibility

As earlier mentioned, there has been a lengthy history of corporate failure linked to governance and reporting failure. The recent high profile corporate failures may have involved larger numbers, but many of the issues highlighted are similar to those raised by cases in past periods. The cumulative impact of high profile cases has led to a steady loss in the credibility of financial statements and the participants involved with producing and reporting on them.

The 1980's and 1990's have many examples of reporting failure, generally associated with governance and business failure. In the U.K., cases of failure include names such as Maxwell, BCCI, Polly Peck and Barings. In France, the collapse of Credit Lyonnais was reported. Germany had Metalgesellschaft and Schneider. In Australia cases of AWA, Bond, Spedley Securities and Tricontinental occurred, while in Canada, Canadian Commercial Bank, Castor Holdings and Roman Corporation collapsed. Japan has Yamaichi, while the U.S. has the many examples from the savings and loan industry as well as cases such as Cendant, Sunbeam, Waste Management, Wedtech, and ZZZZ Best.

The East Asian financial crisis in the second half of 1997 also raised questions about the reliability of financial statements and the role of the large international accounting firms in reporting on them. A report issued by the United Nations Conference on Trade and Development (UNCTAD) in March 1999 considered the corporate reporting implications of the crisis. The report stated that:

"The failure or near failure of many financial institutions and corporations in the East Asian region resulted from a highly leveraged corporate sector, growing private sector reliance on foreign currency borrowings and lack of transparency and accountability. A crucial role was played by disclosure deficiencies. And the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks."

These concerns far-reaching as they were, at least in retrospect, were interpreted rather narrowly, as matters for some Asian countries and not the U.S., Western Europe, Japan, certainly "not for Nigeria" or elsewhere.

In the period to 2001, the stock markets in many of the developed countries had a long period in which prices rose rapidly to historically high levels. In certain sectors, such as telecommunications and e-business, the surge was particularly dramatic. The pressure to deliver performance in line with the expectations of the market was correspondingly high and, in many cases, increasingly focused on maintaining share prices in the short-term. The incentive was there for "creative accounting" and outright falsification to maintain high ratings. The problems arising from deceptive reporting went beyond national boundaries and the accounting profession is yet to recover from the shock waves created by loss of confidence.

The collapse of Enron and the related auditor issues are seen by many as the event that initiated the changed perception of the reliability of financial reporting. As the brief history set out here suggests, it might be better to consider Enron as the event that confirmed a trend and, by its sheer size, awoke many to issues that had been significant for some time. Enron now serves as the benchmark or reference point that gave the issues greater visibility. The larger, but much simpler, reporting failure at WorldCom and issues raised at Global Crossing, Tyco, Adelphia, and Xerox added further examples, reinforcing the perception that financial reporting was not to be relied upon.

### **SELF-ASSESSMENT EXERCISE**

How did loss of credibility originate?

### **3.2 The Global Nature of the Loss of Credibility**

Recent U.K. cases include Independent Insurance and Equitable life. In respect of Ireland's Elan, a pharmaceutical company, questions were raised in relation to accounting, auditor independence and governance issues. The large French multi-national Vivendi added misleading reporting to business and governance issues. ABB, the Swiss-Swedish engineering group, added significant governance and accounting issues to its huge business problems.

Other recent continental European examples include Comroad, where 97% of revenue came from a non-existent company, Babcock-Borsig, Kirsch, Philipp Holzmann and EM- TV in Germany, and Lernout & Hauspie in Belgium. Australia had H1H Insurance, with its substantial

accounting misstatement issues. Governance and accounting questions at Korea's large conglomerates continued, with allegations that the SK Group had inflated profits at one subsidiary by \$1.2 billion. Most recently, the Dutch retailer, Royal Ahold, has been tagged Europe's Enron, given the large numbers involved and the reports of aggressive earnings management, accounting irregularities, ineffective governance, and questions on auditor performance.

It would be observed that all the examples cited were from the developed economies. This does not imply that the developing economies are free from the loss of credibility. Even before the loss became a worldwide phenomenon, users had placed no confidence in financial reporting emanating from the less developed economies mainly because:

- (a) these reports were not produced by the international firms
- (b) they did not involve multinational corporations
- (c) their impact on the international stage was minimal.

Each of the examples provides evidence of reporting failure. Many of the reports suggest the existence of fraud and all point to the failure of corporate governance mechanisms. Many question the effectiveness of the audit process. As the summary indicates, the cases that initiated the recent heightened level of concern were U.S. events, but the levels of the stock markets and industry factors provided rapid linkages to other markets. Governments and other bodies around the world have seen a need to take action, conduct reviews and commission reports. Some have claimed that "it could not happen here" even if history has shown otherwise.

Globalisation of markets continues to be a major factor both for goods and services and for the provision of finance. Securities offerings are no longer limited to an entity's home country, but are frequently offered in multiple jurisdictions. Securities of many companies are now traded on exchanges in a number of countries. For example, during the 1990's, the number of non-U.S. companies listed on a U.S. stock exchange, and therefore subject to SEC reporting, increased threefold to over 1200. Similar increases occurred in foreign listings in other markets.

However, regulation is, and is likely to remain a national matter and therefore the standards which determine how financial statements are presented are national standards. A company with securities listed in more than one country will continue to be subject both to the rules in its home country and those in the other countries in which it is listed. The presence of sets of information that is different in the market, but each of which purports to be a fair presentation, undermine the credibility of

each set. This increases the inefficiency of the market as well as adding unnecessary costs.

The solution to this is not to have every country adopt one country's standards. While prior to Enron, some argued- and not just those based in the U.S that the solution was for all countries to adopt U.S. accounting principles and associated practices. Adopting one country's standards is not likely to be acceptable politically even if it were possible to agree on which country's standards to adopt. The alternative is to agree on a "neutral" set of standards which can be accepted by every country and either adopted as the country's standards or incorporated into them.

### **SELF-ASSESSMENT EXERCISE**

State the evidences that provide that there is loss of credibility.

### **3.3 Recent Developments**

Changes aimed at improving the credibility of financial reporting did not start after the collapse of Enron. They have been ongoing for many years. Intensive efforts have been made in a number of the developed countries to review and address issues such as corporate governance accounting standards and auditor performance and at the international level to develop enhanced standards to guide the national processes of change. A typical example of such effort is the establishment of the Financial Stability Forum. The report of this forum focused on the international standard setters and on developments at the national level, particularly in those countries with well-developed market economies, sets out some of the more significant developments in recent years; it aims to provide some background without attempting a comprehensive survey. Many of the more recent developments noted are still at the proposal stage while others, although they have been put in place, are so new that it is too early to assess their impact.

#### **3.3.1 The Financial Stability Forum**

The Financial Stability Forum (FSF) was established by the 67 Finance ministers in 1999 in an effort to improve the international financial architecture. It was asked to focus on ways in which crises such as the East Asian financial crisis could be avoided or, if they did occur, the consequences could be minimised. The Forum comprises representatives of national Finance Ministries, central banks, other regulatory and government agencies and international institutions. It concluded very quickly that matters would be improved if all countries had strong market foundations with regulatory systems in areas such as banking, insurance and securities that were in line with best practices.

They moved on to identify best practices and from a list of over 60 standards or sets of rules, concluded that there were 12 standards that were the most important. Included in the 12 standards are the following:

- (a) International Financial Reporting Standards, issued by IASB;
- (b) International Standards on Auditing, issued by IAASB;
- (c) The OECD Principles of Corporate Governance; the Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision;
- (d) The Objectives and Principles of Securities Regulation, issued by IOSCO;
- (e) The Insurance Core Principles, issued by the International Association of Insurance Supervisors; and
- (f) Principles on insolvency which are being developed by the World Bank.

The remaining key standards are of less direct relevance to financial reporting and cover transparency in monetary and fiscal policies, fiscal transparency, data dissemination, securities settlement systems and money laundering.

The World Bank and the IMF were given the job of assessing whether individual countries are complying with these standards. The World Bank, in its ROSC (Reports on Standards and Codes) process, has focused on accounting, auditing and corporate governance. Its reviews, primarily in developing countries, have identified many gaps between actual practices and the standards. The reviews have also attempted to identify the causes of non-compliance. From this, the World Bank has facilitated meetings of stakeholders, in both the public and private sectors, to develop plans to upgrade both standards and practices. In its twice yearly meetings and through regional meetings, the Financial Stability Forum has continued to look at ways in which the international organisations can increase the pace of change, through either encouragement and support or external pressure.

### **SELF-ASSESSMENT EXERCISE**

Why was Financial Stability Forum established?

### **3.3.2 The Organisation for Economic Cooperation and Development**

The OECD Principles of Corporate Governance, one of the Financial Stability Forum's 12 key standards, were issued in 1999 and cover five areas: the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the

responsibilities of the board. OECD has started preliminary work toward a 2004 assessment as to whether changes in the Principles are needed.

Although suggestions have been made for expanding the Principles to include detailed "rules" on such matters as the criteria for consolidation of subsidiaries and off-balance sheet finance, the consensus appears to be that the Principles are appropriately named and should not be converted into a detailed set of rules. The FSF has suggested that the Principles should be strengthened to reflect recent improvements in national practices and that more guidance should be provided on implementation and enforcement, major issues in this area as in others.

### **SELF-ASSESSMENT EXERCISE**

List the five areas covered by the OECD Principles of Corporate Governance.

### **3.3.3 The International Organisation of Securities Commissions**

IOSCO, the International Organisation of Securities Commissions, issued a revised set of objectives and principles for securities regulation, another of the FSF's 12 key standards, in February 2002. Among the 30 principles are those related to full, timely and accurate disclosure of financial results (by issuers), the need for high quality and internationally acceptable accounting and auditing standards, and the need for the regulator to have comprehensive inspection, investigation, surveillance and enforcement powers.

The guidance to regulators was expanded when it issued two statements relating to auditing in October 2002. The first statement, on auditor independence, supports the "threats and safeguards" approach underlying IFAC's Code of Ethics, but then indicates that a framework is not sufficient to protect investors without the clarity that comes with specific provisions on activities and relationships considered unacceptable regardless of any safeguards that might be applied. This statement also concludes that there should be requirements for audit firms to maintain internal systems and processes for monitoring, identifying and addressing threats to independence and for ensuring compliance with the standards. This statement also includes the requirement that a governance body, independent of management, should oversee the selection, appointment and remuneration of the auditor and the conduct of the audit.

The second statement sets out principles for auditor oversight, including the need for the audit firm's processes and systems to be assessed and

evaluated by an external oversight body that is seen to act in the public interest. The body would oversee the process for the licensing of auditors, auditor independence and the implementation of auditing standards. It should also establish a process for regular reviews of audit procedures and practices of firms that audit listed companies. All these functions could be performed by a professional body, as they are today in many countries, but where this is so, an independent public interest oversight body should also be in place.

### **SELF-ASSESSMENT EXERCISE**

How did the effort of the IOSCO, the International Organisation of Securities Commissions help in regularising the fraudulent practice in financial reporting?

#### **3.3.4 The European Union**

Among the more significant developments crossing national boundaries have been those within the European Union. Although the E.U. focused, from an early stage, on the importance of financial reporting as a key element in producing a common internal market, the impact of the 4<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> Company Law Directives in providing a high quality common approach to reporting was very limited as countries implemented the Directives with minimum changes from their previous very different practices. Recent developments should produce both improvement and convergence in financial reporting.

The decision to require the use of IFRSs for the consolidated financial statements of listed companies and to allow individual countries to decide whether this requirement should be extended to other companies should improve the financial statements of many companies across the E.U. At the same time, it will put pressure on IASB to deliver on its program of strengthening its standards. The E.U. is putting in place a structure to give input to IASB during the development of standards and to formally approve them. IASB will want to have this approval and the E.U. will want to provide it; this will provide constructive tension in the process, which should be beneficial to all potential users.

In parallel with the decision-making on accounting standards, the European Commission has been focusing on issues related to the quality of auditing and to compliance with standards through its Committee on Auditing. This committee has representatives from each member country government and from the accounting profession. The deliberations in the committee have allowed the E.U. to issue recommendations on external audit quality control and auditor independence. In May 2003, the European Commission issued proposals

for extensive and positive changes in corporate governance and auditing. The corporate governance proposals include requiring an annual corporate governance statement, establishing minimum standards for the composition and role of nomination, remuneration and audit committees, and providing greater transparency and shareholder influence in relation to directors' remuneration. The audit-related proposals include the adoption of ISAs, the strengthening of public oversight of the audit profession and reinforcement of the regulatory infrastructure. The E.C. will also analyse the economic impact of auditor liability regimes.

State the effort of the European Union and how is it in parallel with the decision-making on accounting standards.

### **3.3.5 The International Federation of Accountants**

Standards and regulations are today primarily national matters. The E.U. decision to use international standards in accounting and auditing instead of national standards is intended to change this. At the same time, this decision raises questions of how structures can, practically speaking, be developed or adjusted to support a multilateral approach.

In 2000, IFAC embarked on a four-point plan to strengthen its position as the international standard setter in the audit field and potentially as the international self-regulatory body for the profession.

- (a) The first area to be addressed was audit standard setting. Additional resources have been provided to IAASB, its membership has been widened and its processes have been made more transparent. Discussions continue with representatives of regulators and others as to whether additional changes are needed so that ISAs can receive the necessary acceptance from the regulatory community.
- (b) IFAC has also focused for the first time on whether its member-bodies are complying with IFAC's guidance as to best practice in running a professional body. An initial assessment of the issues has been made and the requirements of member-bodies are being codified and clarified by issuing Statements of Membership Obligation
- (c) The large networks of accounting firms, which perform most of the international audits and most of the audits that have been subject to recent criticism, have been linked more closely to IFAC through the establishment of the Forum of Firms. The Forum is not part of IFAC, but its operational committee, the Transnational Auditors Committee, provides the link through being a committee of both IFAC and the Forum.

- (d) The fourth element in the plan for strengthening IFAC was to have been the establishment of a public oversight body with characteristics similar to the then existing U.S. Public Oversight Board. With the strong criticism of the US. Public Oversight Board post-Enron, this solution for providing public interest input was no longer considered credible, and discussions continue with stakeholders to determine whether there is an alternative approach to obtaining public-interest involvement which would be both beneficial and acceptable.

During this period of restructuring, IFAC has continued to develop new or improved standards in its public interest activities. The Code of Ethics on Auditor Independence, which provided major input to the European Commission's Recommendation on auditor independence, and the completion of a substantial body of International Public Sector Accounting Standards, are two of the main examples. The IFAC Ethics Committee is now focusing on the remainder of the Code, including that part of it related to accountants in industry. The IFAC Board has also underlined its commitment to the public interest by requiring that each board member should confirm this in an oath of office.

### **3.3.6 The International Accounting Standards Board**

The International Accounting Standards Committee (IASC) was founded over 25 years ago by the same accounting professional bodies that founded IFAC. This close association with the profession began to be questioned as IOSCO conducted its review of its standards to determine whether it was appropriate to endorse them. A Task Force with representatives of various stakeholders, including regulators, IFAC and IASC, concluded that IASC should become independent of the profession and that it should have substantially greater resources including a mainly full-time Board. The International Accounting Standards Board (IASB) was the result. IASB is responsible for the development of IFRS5, one of the 12 key FSF standards.

IFRS5 and ISAs are different from the other standards in that they are the only two of the 12 which are developed by private sector bodies. This creates special issues in gaining acceptance by government bodies such as regulators. It means that in addition to accepting the appropriateness of the standards themselves, the regulators need to be satisfied as to the process by which the standards have been produced. This covers areas such as selection of board members, transparency of operation, and input of stakeholders, finance, and public interest oversight.

The restructuring of IASC, to form IASB, appears to have established a basis for acceptance in the area of international accounting standards. IASB is in the midst of upgrading standards in response to concerns of IOSCO, which has endorsed IFRSs subject to resolution of certain issues, and the needs of the European Union, which will require the use of IFRSs for the consolidated financial statements of listed companies from 2005. IASB has also committed to reviewing IFRS5 from the viewpoint of the smaller entity. Members of IASB have been given responsibility for liaison with the accounting standard setters in a number of countries to encourage both cooperation in the use of resources and convergence of standards.

### **SELF-ASSESSMENT EXERCISE**

Enumerate the functions of the International Accounting Standards Board.

### **3.3.7 National Developments**

The national developments that have received the greatest visibility at the international level have been those in the U.S., where the Sarbanes Oxley Act, which was passed in 2002, introduced additional requirements for management of listed companies, stronger corporate governance rules and major changes in the regulation of auditors. SEC regulations will implement the provisions during 2003. However, there have also been significant developments in other countries, many of which predate Sarbanes-Oxley. In the U.K. a series of reviews, starting in 1992, the most recent of which reported in January 2003, has produced extensive changes in corporate governance requirements and in the regulatory structure impacting auditors.

France reviewed various aspects of corporate governance in the Button Report published in September 2002. Developments in Australia, Canada and Japan are also summarised to illustrate the extent of changes being put in place.

### **3.3.8 Requirements of Management**

Sarbanes-Oxley introduces in the U.S. a number of restrictions relating to management that some other countries have had for a number of years. For example, in the interests of protecting auditor's independence, the CEO, CFO, Controller, and Chief Accounting Officer could not be employed by the company's audit firm during the one-year period preceding the audit. In the future, it will also be unlawful to make loans to directors and officers. Directors and officers are also required to disclose their share transactions by the end of the second business day, much more quickly than ever before. Sales of company securities by

directors and officers are now prohibited when company pension fund members generally are barred from doing so during the so-called black-out periods.

The CEO and CFO are now required to prepare a statement to be filed with the quarterly and annual financial statements certifying the "appropriateness of the financial statements and disclosures contained in the report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition" of the company. Annual and quarterly reports are now required to disclose all material off-balance sheet transactions and other relationships with unconsolidated entities.

The SEC is also required to conduct a study of the appropriateness of accounting followed in this area. Management is now required to make and report an assessment of internal controls. The auditor will be required to report on the assessment. Each company is required to disclose whether it has adopted a code of ethics for its senior financial officers and to disclose its contents. The Act also introduces new provisions making it an offense to "fraudulently influence, coerce, manipulate, or mislead" an auditor. The SEC may also bar an individual from being a director or officer of an SEC registrant.

Finally, the CEO and the CFO are now required to repay any bonuses or other incentive or equity based payments and any profits made on the sale of securities where the financial statements are found to be materially noncompliant in the following 12 months.

In 2001, the U.K. Auditing Practices Board issued a paper highlighting issues related to aggressive earnings management. Ireland proposes to introduce in 2003 a requirement for the directors to publish a statement that the company has complied with company, tax and other laws. This statement will need to be reviewed by the auditor.

### **3.7.9 Corporate Governance**

The strengthening of corporate governance has been a key focus in many countries, including all the countries represented on the Task Force. The U.K. has devoted considerable attention to the strengthening of corporate governance, starting with the Cadbury Report in 1992. The resulting Code of Best Practices has been expanded and remains voluntary. However, the Financial Services Authority, in its role as the U.K. regulatory authority, requires that companies that do not comply should explain that fact. The Code covers such matters as the composition of the board, the responsibilities of directors and audit committees and the relationship with auditors. Following from the

Turnbull Report in 1999, listed companies have also needed to report that they have processes for identifying, evaluating and managing significant risk.

Ireland proposes to make major changes in its corporate law in 2003, including strengthening the role of the audit committee with a wide scope, including larger non-listed companies. In May 2001, a French law introduced a new legal framework enabling companies to separate, for the first time and on a voluntary basis, the functions of the chairman and the chief executive. The law also contains provisions on shareholder rights, the responsibilities of the board, prevention of conflicts of interest, and allotment and disclosure of share options.

The Canadian Joint Committee on Corporate Governance, the Saucier Committee, which reported in November 2001, presented a comprehensive set of proposals covering what they identified as the five core functions of a board: choosing the CEO, setting the broad parameters within which management operates, "coaching" the CEO, monitoring and assessing the performance of the CEO, and providing assurance to the shareholders and stakeholders about the integrity of the company's financial performance. Included in the detailed description of these core functions is approving a communications policy that includes a framework for investor relations and a public disclosure policy. The report also emphasises the importance of having the right directors, as well as directors who are independent and introduces the idea of an independent board leader where the chairman is not independent. The committee confirmed the importance of audit committee members being outsiders and unrelated as well as being financially literate, but concluded that it was not necessary to set detailed definitional rules along the lines subsequently introduced in the U.S.

The committee also concluded that the external auditors should be accountable to the board and the audit committee, and not management. Additionally, the committee concluded that where there was no internal audit function, this situation should be reviewed regularly by the audit committee.

Germany introduced its first comprehensive corporate governance code in February 2002. As in some other countries, the code is non-statutory but if a company chooses not to comply, it should disclose that fact. The detail of the code reflects Germany's dual board system of supervisory and management boards. The supervisory board, which has either one-third or one-half employee representatives, depending on the size of the company, may not have more than two members who are former members of the management board. The supervisory board is required to establish an audit committee whose chairman should not be the

chairman of the supervisory board or a former member of the management board. The audit committee has a similar role to committees in other countries.

In Nigeria, the case is not different. As a 2001, the Securities and Exchange Commission (SEC) in collaboration with Corporate Affairs Commission (CAC) constituted a Committee to assess the strength of corporate governance practice in Nigeria. This effort resulted in the issuance in 2003, of the Code of Best Practices on Corporate Governance for publicly quoted companies. The code listed among other things, the composition and powers of the Executives of companies, role of Audit Committees, separation of powers between the Executive Management and the Board, with the effect that the Head of Management, i.e. the Managing Director/Chief Executive Officer should be different from the Head of the Board in order to avoid the concentration of dual powers on one individual. On the strength of the code of corporate governance issued by SEC and CAC, other regulatory agencies such as the Central Bank of Nigeria (CBN) and the Institute of Directors (IOD) issued similar codes in line with the Code of Best Practices on Corporate Governance issued by SEC/CAC. For example, the Central Bank of Nigeria issued in April 3, 2006, what is regarded as Code of Corporate Governance for Banks in Nigeria post-consolidation. The Code was all encompassing and for the first time sets the time limit of external auditors to a bank, and stipulated stiff penalties for erring directors for banks as well as external auditors. Readers are encouraged to study the details of the provisions of these Codes (SEC/CAC and CBN) in Appendix VIII of this pack (page 371).

Sarbanes-Oxley introduces an independence requirement for audit committee members. Committee members may not receive compensation from the company except as a director and may not be affiliated with the company. The company will now be required to disclose whether at least one member of the committee is a financial expert, make a declaration that the Audit Committee members are independent, disclose the committee's charter and produce an annual audit committee report. The committee now becomes responsible for the appointment, compensation and oversight of any accounting firm employed by the company and has the authority to engage outside advisers. The provision of non-audit services rather than pre-approving them, and only requiring a majority of the committee to be independent. On the other hand, it suggested that Audit Committees meet at least once a quarter with the external auditors.

The Higgs and Smith Reports in the U.K. on the role of non-executive directors and on Audit Committees issued in January 2003 make a number of recommendations for change, but still conclude that a

voluntary Code, supported by disclosure which requires the company to indicate whether it is in compliance with the Code or to explain why it is not, is preferable to rules set by law. The Higgs Report confirms the desirability of separating the roles of Chairman and CEO. A draft provision of the Code states that a CEO should not go on to become Chairman of the same company. The report also confirms the provision of the current Code that there should be a senior independent director in addition to the Chairman.

The Higgs Report also suggests that the balance of the board should be such that at least half the Board, excluding the Chairman, are independent of the company. The classification of a director as independent or otherwise is a matter for the board to determine. Among the criteria that would provide a definition of independence to assist the board are that the directors:

- (a) may not have been employees in the previous five years;
- (b) could not have had material business relationships in the previous three years;
- (c) may receive no remuneration beyond a fixed fee;
- (d) can have no family ties with directors, senior employees or advisers;
- (e) can have no cross-directorships with other directors;
- (f) cannot be a representative of a significant shareholder; and
- (g) could not have served on the board for more than 10 years.

The New York Stock Exchange issued new rules in August 2002 incorporating the Sarbanes-Oxley requirements and making a number of them more precise.

The High Level Group of Company Law Experts presented their final report the Winter Report, to the European Commission in November 2002. A key recommendation was that corporate governance issues are best dealt with in national codes, rather than in legislation; and that companies should be required to comply with a Specified national code or explain non-compliance.

This report recommended a major role for the audit committee with a number of differences from the U.S. approach, including, for example, monitoring control system and the effectiveness of internal audit, recommending the appointment and remuneration of the external auditors, and reviewing their independence. The members of the committee should be independent, as defined above, and should include at least one with significant recent, relevant financial experience.

The Toronto Stock Exchange introduced new rules for operation of audit committees in April 2002. The new rules implement many of the recommendations of the Joint Committee on Corporate Governance. All committee members are required to be unrelated and financially literate, with at least one member of the committee being required to have accounting or related financial expertise. The committee is required to have a charter and its functions are similar to those in other jurisdictions, but emphasis is put on discussion with the auditors regarding the quality as well as the acceptability of accounting policies.

Canada also introduced specific corporate governance guidance for federally regulated financial institutions in January 2003. In addition to considering the role of the audit committee, the guidance places substantial emphasis on the role of the board in relation to risk management and internal controls.

The Bouton Report, issued in France in September 2002, proposes a lengthy list of changes to increase the effectiveness of boards of directors. The report considers the composition of the board, including proposing an updated definition of independence, the need for the board to have an evaluation process, the operation of the audit, compensation and nominating committees, and various matters related to stock options. The definition of independence is similar to the Higgs definition. The report also devotes considerable attention to the relations between the board and the auditors. A Government proposal currently in the parliamentary process will merge two French regulatory bodies into a new independent Financial Markets Authority with responsibility for protecting investor rights and improving investor and saver protection.

Proposals issued in September 2002 and effective for 2003, make it compulsory for the first time for the 500 largest Australian listed companies to have Audit Committees. Members will be required to be independent and, as in Canada, be financially literate. Additionally, at least one should have accounting or related financial expertise. The proposals require the committees to have charters covering similar ground to the U.K. in such areas as auditor effectiveness and independence and review of company financial statements, but in the light of some of Australia's recent corporate scandals they add a requirement to review and monitor related party transactions and their propriety.

Japan has strengthened its corporate governance system through amendments to its Commercial Code. The board of statutory auditor system has been enhanced by increasing the number of independent members required. Effective April 2003, listed companies have two options for their corporate structures: they may have, as before, a board

of statutory auditors or have a board of directors with audit, nomination and compensation committees. If a company chooses to retain its board of statutory auditors, at least half of its members will need to be outsiders with no director or employee relationship with the company. If the board and committee structure is chosen, a majority of the members of each committee will need to be independent.

What is Corporate Governance?

### **3.4 Accounting and Auditing Standards**

Country reviews in the area of accounting standards have, in general, confirmed the national structures for developing standards and have supported the role of IASB and the principle of convergence. Sarbanes-Oxley will require changes at the U.S. accounting standard setter, the FASB, specifically in relation to governance and funding, but the standard setter will remain a private sector body. The FASB will need to be more focused on keeping standards current and to consider the extent to which international convergence of standards is necessary or appropriate.

The U.K. review leaves the accounting standard setting process unchanged and confirms the preference for standards based on principles rather than the detailed rules-based approach of the U.S. The French review suggests that the annual report should summarise the company's procedures for identifying off-balance sheet commitments and assessing material risks as well as providing more specific disclosure of the information itself. While supporting the move to convergence of national and international accounting standards, the report is critical of the approach being taken by IASB "in seeking to impose fair value accounting" in relation to derivatives and more generally as to the lack of transparency in its standard-setting process. As part of its program to converge with international standards, Japan has introduced a requirement for fair value accounting of financial instruments.

#### **3.4.1 Auditors and Auditing**

Concerns regarding the competence and independence of auditors have arisen regularly in recent years and have been the subject of a number of committee reports. Although the conclusions in most of these earlier reports have either been superseded by events or repeated in later reports, one recent report that has not been fully implemented is worth a brief mention. The U.S. Panel on Audit Effectiveness which reported in August 2000 was established by the now defunct Public Oversight Board. The panel performed a comprehensive and independent review of the way in which audit work is performed.

It considered audit procedure methodology, firm and external quality control. Among its many recommendations was that there needed to be extensive changes in the then existing U.S. peer review system, as well as many detailed changes in audit procedures, including a greater focus on fraud. Among its other recommendations, which are still relevant, was that the firms put greater emphasis on the performance of high quality work and that IFAC should establish an international self-regulatory system for the auditing profession. The disbandment of the Public Oversight Board and the delays in activating its successor has meant that many of the panel's recommendations have not been implemented.

Sarbanes-Oxley establishes a U.S. Public Company Accounting Oversight Board (PCAOB), appointed by and responsible to the SEC, with much wider powers than the Public Oversight Board. The PCAOB's powers cover the registration of accounting firms, the establishment of auditing, quality control, ethics and independence standards, the inspection of accounting firms and investigations and disciplinary proceedings against accounting firms. The Act sets out detailed requirements that the Board must impose on firms, including the requirement to retain records to support audit reports for a period of at least seven years and a requirement to perform second partner reviews and adopt quality control standards. Annual quality reviews will be required of all firms auditing more than 100 SEC registrants; other firms will need to be reviewed every three years.

The list of services that an auditor may not provide to an audit client has been extended by the inclusion of financial information systems design and implementation and internal audit outsourcing, and now covers:

- (a) Bookkeeping or other services related to the accounting records or financial statements of the client;
- (b) Financial information systems design and implementation;
- (c) Appraisal or valuation services;
- (d) Actuarial services;
- (e) Internal audit outsourcing services;
- (f) Broker or dealer, investment adviser or investment banking services; and
- (g) Legal services.

The lead partner and the reviewing partner must rotate the audit every five years. There will also be a study of the potential effects of requiring mandatory rotation of audit firms.

The auditor will also be required to hold more extensive and structured discussion with the Audit Committee, reporting all "critical accounting

policies and practices to be used all treatments of financial information within accepted accounting practice that have been discussed with management... ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the firm."

The Act, as expanded by the proposals from the New York Stock Exchange and NASDAQ, requires the Audit Committee to be responsible for the appointment, compensation, and oversight of the work of the external auditor, including the resolution of disagreements between management and the auditor regarding financial reporting. The auditor is required to report directly to the audit committee. The audit committee should pre-approve any non-audit services that are provided by the auditor. The audit committee's role is significantly extended to include reviewing:

- (a) Major issues regarding accounting principles and financial statement presentation;
- (b) Analyses prepared by management or internal audit, setting forth significant reporting issues and judgments made in the financial statements;
- (c) The effect of regulatory and accounting initiatives and off-balance sheet structures;
- (d) Earnings press releases and financial information and earnings guidance provided to analysts and rating agencies; and
- (e) Any audit problems encountered during the course of the auditor's work, including management's response.

The Ramsay Report issued in Australia in 2001 considers the independence of auditors in great detail. It recommended changes in a number of areas including:

- (a) Updating existing legislative requirements concerning the independence of auditors;
- (b) Mandatory disclosure of fees paid to auditors for non-audit services, together with an assessment by the audit committee that the services do not impair the auditor's independence;
- (c) Mandatory audit committees for listed companies;
- (d) Requiring the professional accounting bodies to update their ethical codes relating to audit independence;
- (e) A two-year cooling-off period for retired partners of accounting firms who have had audit involvement with a client before they could become a director of that company;
- (f) Mandatory rotation of audit partners every seven years; and
- (g) The establishment of a new monitoring body, the Auditor Independence Supervisory Board, independent of the accounting professional bodies, to oversee the audit profession.

In September 2002, as part of a wider program of corporate law reform, the Australian Government proposed changes in the law relating to auditor independence. These proposals are based largely on the conclusions of the Ramsay Report and are intended to be in place by the end of 2003.

The U.K. proposals reorder the regulatory and standard-setting bodies under a restructured Financial Reporting Council, which will be given statutory authority and whose chair and deputy chair will be appointed by the Government. The Council will have responsibility for:

- (a) The previously independent Accounting Standards Board, which will otherwise remain unchanged;
- (b) The Auditing Practices Board, which will add auditor ethics and independence to its role;
- (c) The Financial Reporting Review Panel, which will, in the future, take a more proactive role in searching for cases of failure to comply with accounting standards;
- (d) An Investigations and Discipline Board, which will consider serious public interest cases of alleged failure by auditors; and
- (e) A Professional Oversight Board, which will take over from the professional bodies' responsibility for the quality inspection process of firms auditing public interest entities.

The U.K. review rejected firm rotation but supported the profession's decision to follow the U.S. by reducing the rotation period for the lead partner, but not for other partners, to five years. The review confirmed the E.U. recommendation on restrictions on non-audit services, including the "threats and safeguards" approach. The review also proposes greatly enhanced transparency on the part of audit firms, including the publication by all firms with listed audit clients, of an annual report providing information on the firm's policies and procedures, especially those related to audit quality and the management of threats to independence, and management and financial information.

The U.K. has also given attention to the relationship between auditors and the board and the audit committee with the Auditing Practices Board, issuing an Auditing Standard (SAS 610), *Communication of Audit Matters to Those Charged with Governance*, in 2001. France has given significant attention to this area over a number of years, starting with the Le Portz Reports in 1992 and 1999. The Bouton Report, issued in September 2002, highlights the French view that its system of joint audits greatly reinforces auditor independence as it should result in all the key issues being reviewed twice. Having a fixed appointment of six years is a further reinforcement.

The report rejects compulsory firm rotation, whilst supporting partner rotation, and concludes that the audit committee should oversee a tendering process at the end of the six years. The report takes a strong line on the provision of non-audit services in concluding that, with the exception of ancillary work, the auditor should carry out no other work for the client.

France is proposing compulsory rotation of audit partners after each six-year fixed term. The soon-to-be established Financial Markets Authority will be required to set up a new audit oversight body, the Council of Statutory Auditors. The new Council will, among other matters, be required to ensure that there is a strict separation of the provision of audit and non-audit services to audit clients. New legislation has recently been passed in the Japanese Diet based on a December 2002 report from a subcommittee of the Financial System Council. Auditor oversight is to be enhanced by having the professional body's (JICPA) system of quality control review monitored by an independent third-party board, the CPA and Auditing Oversight Board (CPAAOB), to be established within the Financial Services Agency (FSA). The FSA will also have a general right to inspect audit firms and require firms and the JICPA to make improvements. The new law focuses on auditor independence. Rules similar to those in place in other countries have been introduced relating to prohibition of certain non-audit services, rotation of engagement and review partners, restriction of employment of former engagement partners and disclosure of audit and non-audit fees.

A further area of change in Japan relates to increasing the number of CPAs. The objective is to provide the capacity to permit an increased volume and quality of auditing.

In parallel with the various national reviews and reports, the accounting firms have also taken action. Three of the four largest firms have now disengaged from performing information systems installation and design work by selling or spinning off that element of their practices.

### **SELF-ASSESSMENT EXERCISE**

What is the applicable auditing standard called?

### **3.5 Analysis**

Sarbanes-Oxley requires the relevant self-regulatory organisations to adopt conflict-of-interest rules for research analysts that recommend equity investments, but otherwise the Act is silent. The most recent U.K. reviews have not considered the role of analysts, although life securities

regulator, the Financial Services Authority, has issued a discussion paper on the conflicts arising in relation to investment research.

The French regulator issued new provisions in April 2002 aimed at strengthening the independence of analysts by managing conflicts of interest and disclosures and by establishing procedures for disseminating research. Effective April 2003, enhanced self-regulatory rules covering the activities of securities analysts were implemented in Japan. Analysts are required to be institutionally independent from investment banking operations, their compensation should not be linked to the performance of investment business, and the analysts and their firms are required to disclose any conflicts of interest relating to the companies they report on. Firms are required to establish review processes which ensure the objectivity and integrity of research reports. Those reports must not be disclosed to companies before publication.

The German Society of Investment Analysts and Asset Management adopted a new Code of Professional Conduct in February 2003. The Code focuses on independence and integrity and requires the disclosure of conflicts of interest. Canada has also introduced new standards to deal with the potential conflicts of interest impacting investment analysts. The Australian Securities and Investments Commission is currently investigating the practices of analysts to determine whether changes in regulations are required. IOSCO is also currently considering the principles that should be applied to investment analysts and credit-rating agencies.

### **3.5.1 Other Changes**

Sarbanes-Oxley (discussed in Chapter 6) requires the SEC to set minimum standards for professional conduct for lawyers practicing before it. The SEC is also to conduct a study of those professionals — accountants, investment bankers, investment advisers, brokers, dealers and lawyers—who may have aided and abetted the violation of securities laws including the filing of materially misleading financial statements. Reviews in other countries do not appear to have considered the role of these other participants.

## **3.6 National Responses in Relation to International Needs**

International needs are most likely to be met if national changes move national standards to the international benchmark standards. Generally, the international standards are principles-based rather than rules-based. In a country with a bias towards rules-based standards, it is possible to have a standard which is intended to be in line with the international standard, but with detailed rules which narrow the application of the

principles and therefore end by not complying with the international standard.

Detailed rules are also a source of unimportant but aggravating differences which make it difficult for a company to comply with standards in more than one jurisdiction. The recent emphasis on having board members who are independent, but with different definitions of independence in different reporting jurisdictions, has produced such differences. Another popular change in regulation requires that an audit committee have financially literate members and that at least one member should have accounting or related financial expertise. The New York Stock Exchange is leaving the definition of financially literate to the board of each company; the Toronto Stock Exchange is also leaving the definition to the board, but will require disclosure of the assessment; NASDAQ has concluded that it is necessary to define financial literacy. Defining accounting or related financial expertise is being left to the board in Canada.

These differences in corporate governance codes or regulations only matter to companies if they are listed in more than one country and are required to comply with each national set of rules.

Where the national rules, although different, complied with a benchmark standard, Sarbanes-Oxley does not recognise this approach as far as the U.S. is concerned.

The situation with accounting standards is still of more concern. A recent survey of knowledgeable investors (McKinsey Global Investor Opinion International needs are most likely to be met if national changes move national standards to the international benchmark standards. Survey on Corporate Governance 2002) showed 90% of investors supporting a single set of accounting standards, but with 78% of those in Western Europe concluding that the standards should be IFRSs while 76% of those in North America thought that the single set should be U.S. generally accepted accounting principles. If this difference of view prevails with the national standard setters, there will continue to be a major credibility issue, with at least two sets of standards being used to produce financial statements that present fairly.

### **SELF-ASSESSMENT EXERCISE**

What is the extent of national response in relation to International needs?

### 3.7 Social/Environmental Audits

Social Audits have to do with the extent to which a company gets involved and interacts with the society in which it operates including the welfare of its employees, In this regard, a company does not just operate for profit, even though this may be the primary motive, but a company cannot operate in isolation. Social audit will therefore consider:

- (a) The company's policy on staff incentives, pensions and welfare, recreational facilities and conveniences;
- (b) The company's pricing policy, product safety, quality control, warranty effectiveness, advertising integrity, debt settlement and collection methods; and
- (c) Environmental protection policies and safety measures.

Businesses have grown in size and scope. Consequently, they have made great impact on the lives and well-being of individuals and the society in which they operate. Ordinarily, the primary concern of corporate governance focuses on:

- (a) customers
- (b) suppliers
- (c) government
- (d) competitors
- (e) labour unions.

In addition to these, there has been a growing interest in the way businesses interface with their environment. This has become paramount as the success and continued existence of business may not depend on the profit achieved or its service delivery to customers, but its relationship with the society at large.

There are external considerations to social audit. This has to do with public perception of the organisation which determines the reputation of the company and a guide to the quality of its products and service delivery.

Social audit also extends to environmental audit where the auditor assesses and reports on the extent to which the organisation works to protect the environment in the interest of future generations. In extreme cases, where damage is done to the environment as a direct consequence of industrial activities, pressure groups of 'green movements' are known to have taken strong actions to coerce corporate governance to be more environmental friendly.

## **SELF-ASSESSMENT EXERCISE**

What do you understand by social audits and environmental audits?

### **3.7.1 Health and Safety of Employee's**

Beyond the law relating to factory regulations and safety, there is an added responsibility on the part of management to consider the health and welfare of employee's as paramount in its overall corporate responsibilities. The factors which are indicators of management concerns for the health and safety of employees include:

- (a) A key officer being responsible for promoting this function;
- (b) A health committee of senior representatives of each work area;
- (c) Health and safety being firmly on the agenda of board meetings;
- (d) Safety training for line managers and operatives;
- (e) Suitable publications and safety signs located across the organisation;
- (f) A policy that locates responsibility for health and safety with management;
- (g) A risk-based approach that seeks to identify key potential problem areas;
- (h) A budget for the use of health and safety experts wherever necessary;
- (i) A zero-accident policy that is fully supported throughout the organisation; and
- (j) A procedure for investigating the cause of accidents, near-accidents and relevant incidents.

## **SELF-ASSESSMENT EXERCISE**

Outline the factors which are indicators of management concerns for the health and safety of employees

### **3.7.2 Business Ethics and Code of Conduct**

Companies now pay a great deal of attention to its corporate code of conduct and business ethics. This may be raised to a strategic level and advertised just like any other products or services of the company. The auditor should objectively assess the extent of standards of ethics demonstrated by the management to be adopted by employees down the line. This has the unquantifiable benefit of discouraging fraud on the part of staff. Part of the business ethics which may make remarkable impact on the staff is the policy of equal opportunity for all regardless of race, religion, gender or physical disabilities. The auditor will also need to assess mechanisms in place for staff selection and appraisal for staff elevation.

## **SELF-ASSESSMENT EXERCISE**

How can you relate business ethics with code of conduct?

### **3.7.3 Environmental Pollution**

The bottom line in environmental audit is management's concern and reaction to matters relating to the physical impact of its business activities in terms of pollution.

This may include river pollution, wildlife destruction, chemical emission, soil excavation, dumping of rubbish and uncontrolled disposal of toxic waste. The ability to strike a balance and be accorded high rating in matters relating to social audit is a good measure of responsible corporate image and social conscience of an organisation.

## **SELF-ASSESSMENT EXERCISE**

List out what you know that can cause environmental pollution.

## **4.0 CONCLUSION**

In this unit, we have looked at how loss of credibility began, the recent development which tries to alleviate such problems, social and environmental audit, the extent at which nationals respond to International need and what led to environmental audit.

## **5.0 SUMMARY**

Financial failures led to the loss of credibility in financial reporting. Social audits have to do with the corporate image of an organisation in its relation with its employees and the society in which it operates. Social audits consider such matters as employee's health and welfare, the business ethics and code of conduct adopted by the organisation and the attitude of the organisation to the environment.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. How did loss of credibility originate?
2. Mention the organisation that worked hard to make sure that loss of credibility was restored.
3. Enumerate the causes of loss of credibility.

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

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## **UNIT 4 INFORMATION TECHNOLOGY ISSUES IN ADVANCED AUDIT AND ASSURANCE 1**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
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  - 3.3 IT Control Activities/COBIT
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    - 3.3.3 Application of COBIT in Business Process
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- 5.0 Summary
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### **1.0 INTRODUCTION**

In this unit, we will discuss Information Technology issues in the areas of IT General Controls (ITGC),

### **2.0 OBJECTIVES**

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

- explain internal control in a computer environment
- discuss IT governance
- state IT control activities
- discuss systems evaluation and procedural controls.

### **3.0 MAIN CONTENT**

#### **3.1 IT General Controls (ITGC)**

ITGC represent the foundation of the IT control structure. They help ensure the reliability of data generated by IT systems and support the

assertion that systems operate as intended and that output is reliable. ITGC usually include the following types of controls:

- (a) Control Environment, or those controls designed to shape the corporate culture or "tone at the top" as enunciated by COSO.
- (b) Change management procedures - controls designed to ensure changes, meet business requirements and are authorised.
- (c) Source code/document version control procedures - controls designed to protect the integrity of program code
- (d) Software development life cycle standards - controls designed to ensure IT projects are effectively managed.
- (e) Security policies, standards and processes - controls designed to secure access based on business need.
- (f) Incident management policies and procedures - controls designed to address operational processing errors.
- (g) Technical support policies and procedures - policies to help users perform more efficiently and report problems.
- (h) Hardware/software configuration, installation, testing, management standards, policies and procedures.
- (i) Disaster recovery/backup and recovery procedures, to enable continued processing despite adverse conditions.

### **SELF-ASSESSMENT EXERCISE**

State four different IT General controls you know.

### **3.2 IT Application Controls**

IT application or program controls are fully-automated (i.e., performed automatically by the systems) and designed to ensure the complete and accurate processing of data, from input through output. These controls vary based on the business purpose of the specific application. These controls may also help to ensure the privacy and security of data transmitted between applications. Categories of IT application controls may include:

- (a) Completeness checks - controls that ensure all records were processed from initiation to completion.
- (b) Validity checks - controls that ensure only valid data is input or processed.
- (c) Identification - controls that ensure all users are uniquely and irrefutably identified.
- (d) Authentication - controls that provide an authentication mechanism in the application system.
- (e) Authorisation - controls that ensure only approved business users have access to the application system.
- (f) Problem management - controls that ensure all application

- problems are recorded and managed in a timely manner.
- (g) Change management - controls that ensure all changes on production environment are implemented with preserved data integrity.
  - (h) Input controls - controls that ensure data integrity fed from upstream sources into the application system.

### SELF-ASSESSMENT EXERCISE

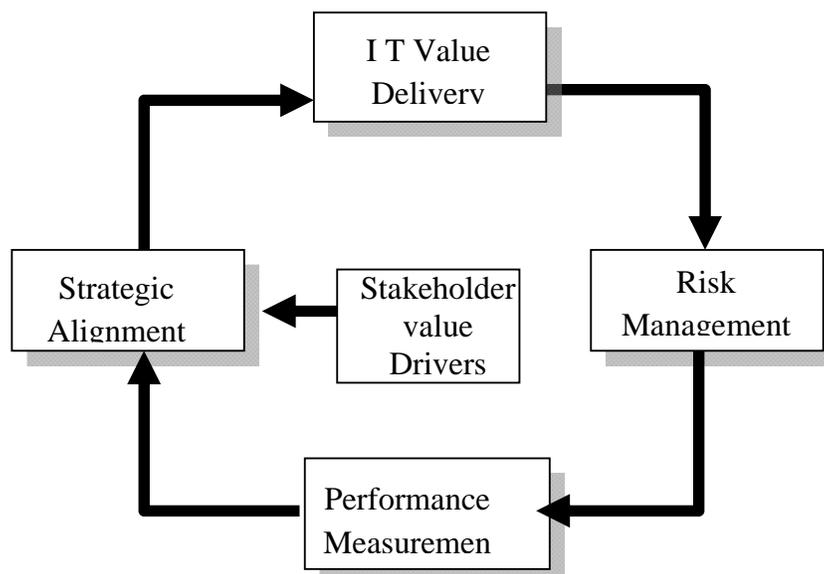
State four different IT Application controls you know.

### IT Governance Issues

IT Governance is a subset discipline of Corporate Governance focused on information technology (IT) systems, their performance and risk management. IT Governance is a set of processes and functions (carried out in a structure of relationships as depicted in Figure 4.1) used in ensuring that the enterprise's IT operations are in the proper direction and under control towards the achievement of its goals and objectives.

Modern IT governance implies a system in which all stakeholders, including the board, internal customers, and in particular departments such as finance, have the necessary input into the decision making process as against the traditional system which defers all key decisions to the company's IT professionals only.

This prevents IT professionals from independently making and later being held solely responsible for poor decisions. It also prevents critical users from later finding that the system does not behave or perform as expected.



**Fig. 4.1: IT Governance Structure of Relationships**  
**SELF-ASSESSMENT EXERCISE**

Explain the IT Governance Structure of Relationships.

### **3.2.1 IT Governance Framework**

IT Governance should operate within the following framework to achieve its goals and objectives:

- (i) The board, not the IT function, should be the prime driver for IT governance. It should provide a framework for governance for a standardised communication interface and channel, for governance, along with simple rules to align and inform everyday decisions and actions toward sustainable financial results;
- (ii) As with the corporation as a whole, sustained financial results should be the objective, prime driver for IT decisions and actions;
- (iii) Govern assets with the purview of IT governance (infrastructure clients and external stakeholders, internal people and process including suppliers and partners, and value creation). Govern assets should include managing the current and propelling towards future state of the enterprise;
- (iv) Since governance is behaviour-driven, emphasis in implementing this framework should be on changing behaviour rather than introducing or changing work artefacts. Roles should be set out, including expected behaviour changes, not just for the board and top management, but for auditors (IT, security, financial), internal staff and external entities (such as suppliers); and
- (v) Other IT governance activities (such as IT service continuity management) and frameworks (such as the IT Infrastructure Library) should be aligned within the corporate governance framework, including program office, project, financial/investment processes, service-level management, business/IT alignment, security and IT audit/conformance, and IT service management processes.

### **SELF-ASSESSMENT EXERCISE**

Which are the various frameworks IT Governance should operate to be able to achieve its goals?

### **3.2.2 Level of IT oversight in the Organisation**

IT oversight function in an organisation comprises the following:

- (i) Evaluation of IT Governance effectiveness-this is to ensure that there is adequate control of the board over the decisions,

- directions and IT performance;
- (ii) Evaluation of human resource management and the operating organisation structure in the IT environment; this is to ensure that they support the organisation's strategic objectives;
  - (iii) Evaluation of the strategies and processes adopted for IT operations to ensure they align with the organisation's overall objective;
  - (iii) Evaluation of IT operational policies, standards and procedures for their development and implementation, to ensure their support for the IT strategy and ,compliance with regulatory and legal standards;
  - (iv) Evaluation of the practices of IT resource investment, use and allocation to ensure alignment with the organisation's overall strategies and standards;
  - (v) Evaluation of the organisation's risk management practices to ensure its, proper implementation; and
  - (vi) Evaluation of management practices to ensure that they comply with the organisation's IT strategies.

### **SELF-ASSESSMENT EXERCISE**

What comprises the IT oversight function in an organisation?

### **3.2.3 Knowledge of IT in the Oversight Board**

Knowledge of IT is required in the oversight board if the board will be effective in its functions. The following are the levels or areas of IT knowledge required in the IT oversight board:

- (i) The reasons behind IT strategies, policies and standards and their essential elements;
- (ii) The frameworks within which the IT governance operates;
- (iii) The processes involved in the development, implementation and maintenance of IT strategies, policies and standards;
- (iv) The organisation's IT architecture and its impact and significance in setting long-term strategic directions;
- (v) The operations of the IT control frameworks (e.g. COBIT, COSO,);
- (vi) The IT risk management methodologies and tools;
- (vii) Quality management strategies and policies.

### **3.3 I T Control Activities**

IT control activities are derived from the IT control framework - COBIT discussed below.

## **COBIT (Control Objectives for Information and Related Technologies)**

COBIT is an IT governance tool that has been of tremendous benefits to IT professionals and has contributed immensely to effective control of information systems linking information technology and control practices, COBIT consolidates and harmonises standards from prominent global sources into a critical resource for management control professionals and auditors. As such, COBIT represents an authoritative, up-to-date control framework, a set of generally accepted control objectives and a complementary product that enables the easy application of the Framework and Control Objectives, referred to as the Audit Guidelines.

COBIT applies to enterprise-wide information systems, including personal computers, mini-computers, mainframes and distributed processing environments. It is based on the philosophy that IT resources need to be managed by a set of naturally grouped processes in order to provide the pertinent and reliable information which an organisation needs to achieve its objectives. With the addition of the management guidelines, COBIT now supports self-assessment of strategic organisational status, identification of actions to improve IT processes and monitoring of the performance of these IT processes. Since the first edition of COBIT was released in 1997 it has been sold and implemented in over 100 countries of the world.

COBIT has been developed as a generally applicable and accepted standard for good information technology (IT) security *and* control practices that provides a reference framework for management, users and information system audit as well as control and security practitioners.

### **SELF-ASSESSMENT EXERCISE**

Discuss COBIT as a framework of IT Control.

#### **3.3.1 The Purpose of COBIT**

The purpose of COBIT is to provide management and business process owners with Information Technology (IT) governance model that helps in understanding and managing the risks associated with It COBIT helps to bridge the gaps between business risks, control needs and technical issues. It is a control model to meet the needs of IT governance and ensure the integrity of information and information system.

## **SELF-ASSESSMENT EXERCISE**

What is the purpose of COBIT?

### **3.3.2 The Users of COBIT**

COBIT is being used by those who have the primary responsibilities for business processes and technology; those who depend on technology for relevant and reliable information, as well as those providing quality reliability and control of information technology.

## **SELF-ASSESSMENT EXERCISE**

Who are the users of COBIT?

### **3.3.3 Application of COBIT in Business Process**

COBIT is business process oriented and therefore addresses itself in the first place to the owners of these processes. Generic business model refers to core processes such as procurement, operations, marketing, sales, etc., as well as support processes (human resources, administration, information technology). As a consequence, COBIT is not applied only by the IT department, but also by the business as a whole.

The above approach stems from the fact that in today's enterprises, the process owners are responsible for the performance of their processes of which IT has become an integral part. In other words, they are empowered, but also accountable.

As a consequence, the business process owners bear the final responsibility for the information technology as deployed within the confines of business processes. Of course, they will make use of services provided by specialised parties like the traditional IT department or the third party service provider. COBIT provides the business process owners with a framework which should enable them control all the different activities underlying IT deployment. As a result, they can gain reasonable assurance that IT will contribute to the achievement of their business objectives. Moreover, COBIT provides the business process owners with a generic communication framework to facilitate understanding and clarity among the different parties involved in the delivery of IT services.

Furthermore, the addition of the Management Guidelines in the third edition of COBIT provides management with a set of tools. These allow self-assessment in order to make choices for control implementation and

improvements over IT, measure the achievement of goals and the proper performance of IT processes. The Management Guidelines include maturity models, critical success factors, key goal indicators and key performance indicators to support managerial decision making.

### **SELF-ASSESSMENT EXERCISE**

Explain the application of COBIT in Business Process

#### **3.3.4 COBIT Overview**

COBIT, issued by the IT Governance Institute and now in its third edition is increasingly internationally accepted as good practice for control over information, IT and related risks. Its guidance enables an enterprise to implement effective governance over the IT that is pervasive and intrinsic throughout the enterprise. In particular, COBIT's Management Guidelines component contains a framework which responds to management's need for control and measurability of IT by providing tools to assess and measure the enterprise's IT capability for the 34 COBIT IT processes.

The tools include:

- (a) Performance measurement elements (outcome measures and performance drivers for all IT processes) ;
- (b) A list of critical success factors that provides succinct, non-technical best practices for each IT process; and
- (c) Maturity models to assist in benchmarking and decision-making for capability improvements.

COBIT components include:

- (i) Management Guidelines;
- (ii) Executive Summary;
- (iii) Framework;
- (iv) Control Objectives;
- (v) Audit Guidelines; and
- (vi) Implementation Tool Set.

The components are briefly discussed, as follows:

#### **3.3.5 Management Guidelines**

To ensure a successful enterprise, one has to effectively manage the union between business processes and information systems. The new *Management Guidelines* are composed of Maturity Models, to help

determine the stages and expectation levels of control and compare them against industry norms. Critical Success Factors, to identify the most important actions for achieving control over the IT processes; Key Goal Indicators, to define target levels of performance; and Key Performance Indicators, to measure whether an IT control process is meeting its objective. These *Management Guidelines* will help answer the questions of immediate concern to all those who have a stake in enterprise success.

### **Executive Summary**

Sound business decisions are based on timely, relevant and concise information. Specifically designed for time pressed senior executives and managers, the COBIT consists of an executive overview which provides thorough awareness and understanding of COBIT's key concepts and principles. Also included is a synopsis of the *Framework*. It provides more detailed understanding of these concepts and principles, while identifying COBIT's four domains (Planning & Organisation, Acquisition & Implementation, Delivery and Support, and Monitoring) and 34 IT processes.

### **Framework**

A successful organisation is built on a solid framework of data and information. The *Framework* explains how IT processes deliver the information that the business requires to achieve its objectives. This delivery is controlled through 34 high-level control objectives, one for each IT process, contained in the four domains. The *Framework* identifies which of the seven information Criteria (effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability), as well as which IT resources (people, applications, technology, facilities and data) are important for the IT processes to fully support the business objective.

### **Audit Guidelines**

To achieve desired goals and objectives one has to constantly and consistently audit one's procedures. *Audit Guideline* outlines and suggest actual activities to be performed corresponding to each of the 34 high-level IT control objectives, while substantiating the risk of control objectives not being met. *Audit Guidelines* are invaluable tool for information system auditors in providing management assurance and/ or advice for improvement.

**Control Objectives** - The key to maintaining profitability in a technologically changing environment is how well control is maintained. COBIT's *Control Objectives* provide the critical insight needed to delineate a clear policy and good practice for Information Technology

controls\_ Included are the statements of desired results or purposes to be achieved by implementing the specific and detailed control objectives throughout the 34 Information Technology processes.

### **Implementation Tool Set**

*Implementation Tool Set* contains Management Awareness and IT Control Diagnostics, Implementation Guide FAQs, case studies from organisations currently using COBIT and slide presentations that can be used to introduce COBIT into organisations.

The new Tool Set is designed to facilitate the implementation of COBIT, relate lessons learned from organisations that quickly and successfully applied COBIT in their work environments, and lead management to ask about each COBIT process: Is this domain important for our business objectives? Is it well performed? Who does it and who is accountable? Are the processes and control formalised?

### **SELF-ASSESSMENT EXERCISE**

Mention and discuss the components of COBIT

## **3.4 IT Control Governance**

IT controls are often described in two categories: IT general controls (ITGC) and IT application controls. ITGC include controls over the information technology (IT) environment, computer operations, access to programs and data, program development and program changes.

Information Technology (IT) application controls refer to transaction processing controls sometimes called "input-processing-output" controls. Information technology controls have been given increased prominence in corporations listed in the United States by the Sarbanes-Oxley Act. The COBIT Framework (Control Objectives for Information Technology) is a widely-used framework promulgated by the IT Governance Institute, which defines a variety of ITGC and application control objectives and recommended evaluation approaches.

IT departments in organisations are often led by a Chief Information Officer (CIO) who is responsible for ensuring that effective information technology controls are utilised. Chief information officers are responsible for the security, accuracy and the reliability of the systems that manage and report the company's data, including financial data. Financial accounting and Enterprise Resource Planning systems are integrated in the initiating, authorising, processing, and reporting of financial data and may be involved in Sarbanes Oxley compliance, to

the extent that they mitigate specific financial risks.

#### **4.0 CONCLUSION**

IT General Controls ensure the reliability of data generated by IT systems and support, IT application controls and accurate processing of data, from input through output. It is a subset of corporate governance focused on IT systems, their performance and risk management.

#### **5.0 SUMMARY**

Information technology controls (or IT controls) are specific activities performed by persons or systems designed to ensure that business objectives are met. They are a subset of an enterprise's internal control. IT control objectives relate to the confidentiality integrity, and availability of data and the overall management of the IT function of the business enterprise.

#### **6.0 TUTOR-MARKED ASSIGNMENT**

1. What is IT Application controls?
2. Controls that ensure that data integrity fed from upstream sources into the application system are referred to as \_\_\_\_\_
3. Controls over IT environment, computer operations as well as access to programs are some of the \_\_\_\_\_ of COBIT

#### **7.0 REFERENCES/FURTHER READING**

- Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.
- ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.

## **UNIT 5 INFORMATION TECHNOLOGY ISSUES IN ADVANCED AUDIT AND ASSURANCE 2**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
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  - 3.3 Auditor's Role in System Development Life Cycle
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### **1.0 INTRODUCTION**

In this unit, we will further advance in information technology issues relating to IT risk assessment and Auditors role in Systems Development Life Cycle (SDLC); as well, IT governance issues will be discussed.

### **2.0 OBJECTIVES**

After studying this unit, you should be able to:

- explain IT risk assurance methodologies and process
- discuss disaster recovery
- describe networking (protocols and standards)
- discuss communication risks.

### **3.0 Main Content**

#### **3.1 IT Risk Assessment and Measurement**

In conducting IT risk measurement and impact analysis, consideration should be given to the advantages and disadvantages of quantitative

versus qualitative assessments. The main advantage of the qualitative impact analysis is that it prioritises the risks and identifies areas for immediate improvement in addressing the vulnerabilities. The disadvantage of the qualitative analysis is that it does not provide specific quantifiable measurements of the magnitude of the impacts, therefore making a cost-benefit analysis of any recommended controls difficult.

The major advantage of a quantitative impact analysis is that it provides a measurement of the impacts' magnitude which can be used in the cost-benefit analysis of recommended controls. The disadvantage is that, depending on the numerical ranges used to express the measurement, the meaning of the quantitative impact analysis may be unclear, requiring the result to be interpreted in a qualitative manner. Additional factors often have to be considered to determine the magnitude of impact.

### **SELF-ASSESSMENT EXERCISE**

What are the major advantages and disadvantages of a quantitative impact analysis?

#### **3.1.1 A Quantitative Approach to Risk Analysis**

This includes:

- (a) Quantitative analysis uses risk calculations that attempt to predict the level of monetary losses and percentage of chance for each type of threat.
- (b) Quantitative risk analysis also provides concrete probability percentages when determining the likelihood of threats.
- (c) Each element within the analysis (asset value, threat frequency, severity of vulnerability, impact damage, safeguard costs, safeguard effectiveness, uncertainty, and probability items) is quantified and entered into equations to determine total and residual risks.
- (d) Purely quantitative risk analysis is not possible, because the method attempts to quantify qualitative items, which are always uncertainties in quantitative values.

### **SELF-ASSESSMENT EXERCISE**

Explain the quantitative approach to risk analysis.

### 3.1.2 Sample Steps for a Quantitative Risk Analysis

Step 1: Assign values to assets - For each asset, to determine its value, answer the following questions:

- (a) What is the value of this asset to the company?
- (b) How much does it cost to maintain?
- (c) How much does it make in profits for the company?
- (d) How much would it be worth to the competition?
- (e) How much would it cost to re-create or recover?
- (f) How much did it cost to acquire or develop?
- (g) How much liability are you incurring for the protection of this asset?

Step 2: Estimate potential loss per threat- To estimate potential losses posed by threats, the following questions should be answered:

- (a) What physical damage could the threat cause and how much would that cost?
- (b) How much loss of productivity could the threat cause and how much would that cost?
- (c) What is the value lost if confidential information is disclosed?
- (d) What is the cost of recovering from this threat?
- (e) What is the value lost if critical devices were to fail?
- (f) What is the single loss expectancy (SLE) for each asset, and each threat?

Step 3: Perform a threat analysis- Take the following steps to perform a threat analysis:

- (a) Gather information about the likelihood of each threat taking place from people in each department, past records and official security resources that provide this type of data; and
- (b) Calculate the annualised rate of occurrence (ARO), which (show many times the threat can take place in a 12-month period;

Step 4: Derive the overall loss potential per threat-To derive the overall loss potential per threat, do the following:

- (a) Combine potential loss and probability;
- (b) Calculate the annualised loss expectancy (ALE) per threat by using the information calculated in the first three steps;
- (c) Choose remedial measures to counteract each threat; and
- (d) Carry out cost/benefit analysis on the identified countermeasures.

Step 5: Reduce, transfer, or accept the risk- For each risk, you can choose whether to reduce, transfer or accept the risk:

- (1) Risk reduction methods:
  - (a) Install security controls and components;
  - (b) Improve procedures;
  - (c) Alter environment;
  - (d) Provide early detection methods to catch the threat as it is happening and reduce the possible damage it can cause;
  - (e) Produce a contingency plan of how business can continue if a specific threat takes place, reducing further damages there from;
  - (f) Erect barriers to the threat; and
  - (g) Carry out security-awareness training.
- (2) Risk transfer - take insurance to transfer part of the risk.
- (3) Risk acceptance - live with the risks and spend no more money toward protection.

### **SELF-ASSESSMENT EXERCISE**

Outline the steps for a quantitative risk analysis.

#### **3.1.3 Quantitative Risk Analysis Metrics**

- (a) Single loss expectancy (SLE) - The amount of loss due to a single occurrence of a threat.
- (b) Annualised loss expectancy (ALE) - The estimated loss per annum.
- (c) Exposure factor (EF) - Represents the percentage of loss a realized threat could have on a certain asset.
- (d) Annualised rate of occurrence (ARO) — It is the value that represents the estimated frequency of a specific threat taking place within a one-year time-frame. It can range from 0.0 to 1.0.

The example below shows the relation between the four metrics discussed above:

- (a) Asset value \* exposure factor (EF) = SLE  
 Example: If a data warehouse has asset value of N150,000, and if it is estimated that if a fire were to occur, 25 per cent of the warehouse would be damaged, then  $SLE = 0.25 * 150,000 = 37,500$ .

- (b)  $SLE * \text{Annualized rate of occurrence (ARO)} = ALE$ . If ARO is 0.1 (indicating once in ten years), then the ALE, =  $37,500 * 0.1 = 3,750$ . This informs the company that if, it wants to put in controls or safeguards to protect the asset from this threat, it can sensibly spend 3,750 or less per year.

### **SELF-ASSESSMENT EXERCISE**

Itemise the four Quantitative risk analysis metrics you know.

#### **3.1.4 Advantages of a Quantitative Method**

- (a) It is easier to automate and evaluate;
- (b) It is used in risk management performance tracking;
- (c) It provides credible cost/benefit analysis; and
- (d) It shows clear-cut losses that can be accrued within a year.

Disadvantages of a quantitative method

- (a) Calculations are more complex. Can management understand how these values were derived?
- (b) Without automated tools, this process is laborious.
- (c) There is a big need to gather detailed information about environment
- (d) Its standards are not available. Each vendor has its own way of interpreting the processes and their results.

#### **3.1.5 Qualitative Approach to Risk Analysis**

- (a) In qualitative approach, one walks through different scenarios of risk possibilities and rank the seriousness of the threats and the validity of the different possible countermeasures.
- (b) The qualitative analysis techniques include judgment, best practices, intuition and experience.
- (c) Qualitative risk analysis techniques are:
  - (i) Delphi - A group decision method used to ensure that each member gives honest opinion of what he or she believes will be the impact of a particular threat. This method is used to obtain an agreement on cost, loss values and probabilities of occurrence, without individuals having to agree verbally;
  - (ii) Brainstorming.
  - (iii) Storyboarding;
  - (iv) Focus groups;
  - (v) Surveys;

- (vi) Questionnaires;
- (vii) Checklists;
- (viii) One-on-One meetings; and
- (ix) Interviews.

#### Advantages of Qualitative approach

- (a) It requires simple calculations;
- (b) It involves a high degree of guesswork;
- (c) It provides general areas and indications of risk; and
- (d) It provides the opinions of the individuals who know the processes best.

#### Disadvantages of Qualitative approach

- (a) The assessments and results are basically subjective;
- (b) It usually eliminates the opportunity to create a dollar value for cost/benefit discussions;
- (c) It is difficult to track risk management objectives with subjective measures; and
- (d) Its standards are not available. Each vendor has its own way of interpreting the processes and their results.

### **SELF-ASSESSMENT EXERCISE**

Mention the Qualitative risk analysis techniques.

### **3.2 Computer Disaster Recovery Issues**

Computer disaster recovery issue addresses the question of business continuity should the system fail and to what extent can the system continue to operate without the critical systems in place. In major complex system environments, the plans usually referred to as back-up' range from simple data 'backup' procedures to creating recovery centres such as establishing 'hot sites', 'cold sites' or 'warm sites'. Sometimes organisations in similar industries may go into what is referred to as "trust relationship." This is the weakest in the chain of recovery strategies due largely to its loose legal colouration.

To understand how severe the impact of a disastrous event could be, the following case will be examined:

The Northridge Earthquake in January 17, 1994; 4:31a.m. The company involved was Great Western Bank, with \$44.6 billion in assets, 300 retail branches in California, 120 retail branches in Florida, 200 residential real estate lending offices throughout the US, 258 consumer finance offices primarily in the Southern U.S.

Damage was highlighted as follows: 3,500 employees without office space, hundreds of employees without homes, 15 to 17 Great Western buildings unusable, two of which were lost long-term, no water, no power. Recovery; the company announced an on-site recovery live within four hours. Their bank examiners called right away to find out what they were doing, and they were able to say "We're having a cup of coffee and reading the Wall Street Journal, how about you?"

Brief discussion of the key alternative recovery strategies are highlighted below:

- (a) Dedicated contingency facilities ("hot sites"): Fully equipped computer facilities for use in the event of one of its subscribers or customers suffering a computer disaster. Periodic computer testing time is made available to customers. Costs associated with third party 'hot sites' are usually very high but justifiable for critical applications. When properly planned, insurance coverage will usually off-set the cost incurred for using this type of facility. Basic subscription cost, monthly fee, activation cost for actual emergency and hourly or daily usage charges.

These charges will usually vary across various vendors, as some of them will usually impose high activation cost to discourage frivolous use of the facility. Companies which can afford to build their own recovery facilities will generally free themselves from the encumbrances of leased facilities.

- (b) Empty shell facilities ("cold sites"): A fully prepared computer room maintained by an organisation or a vendor. Includes data communication systems, security systems, air conditioning, humidity controls, raised floors, storage and office space, and electrical power. In the event of a disaster, the computer vendor delivers the required hardware and equipment to the empty shell facility. Usually, empty shell facilities also provide off-site storage of computer files (programs and data), Documentation, supplies and source documents, activation of this site may take several weeks.
- (c) Warm Sites: These are partially configured sites, usually with network connections and selected peripheral equipment such as: disk drives, tape drives and controllers, no main computer, sometimes a warm site is equipped with a less powerful CPU than the one originally used. The idea behind a 'warm site' is that the computer can be obtained quickly for emergency installation.
- (d) Rolling recovery sites: this uses the concept of "computer rooms on wheels," -where a reloadable, self-contained recovery site with

environmentally, conditioned space (including raised floors, air conditioning, fire protection, diesel power generators, and adequate security) provided by an organisation for a fee for emergency computing and telecommunication line purposes.

The idea is to set up a data centre in a parking lot near the damaged building. Some of the advantages of a rolling cold site telecommunication can be reconnected from a point where the communication lines terminated at a manhole. Doing that saves cost in both time and money of travelling to the nearby hot site.

Other alternatives include the following:

- (e) Vendor back-up' facilities where major hardware vendors offer their facilities to selected customers in the event of a major computer disaster.
- (f) Company multiple sites: based on the concept of redundancy; each site is configured to support the company's combined computer processing.
- (g) Commercial service bureaus: these provide backup and recovery services for their users or customers.
- (h) Mutual aid agreements: "one organisation agrees to provide back-up and recovery facilities for another organisation with a compatible hardware and software configuration, and vice versa...." when earthquake destroyed its network in January 1994; the campus ran its administrative database for several months from a sister campus. It worked out well, but it would have been better to have it set up before the earthquake." (Sue Curzon, vice provost for California State University at Northridge).

### **SELF-ASSESSMENT EXERCISE**

Briefly discuss the key alternative recovery strategies.

### **3.3 Auditors' Role in Systems Development Life Cycle**

Systems Development Life Cycle (SDLC) or *Software Development Life Cycle* is a terminology used in systems engineering and software engineering. It refers to the process of creating or altering systems, and the models and methodologies that people use to develop these systems. The concept generally refers to computer or information systems.

In software engineering the SDLC concept underpins many kinds of software development methodologies. These methodologies form the framework for planning and controlling the creation of information systems; the software development process.

Systems Development Life Cycle (SDLC) is any logical process used by a systems analyst to develop an information system, including requirements, validation, training, and user ownership. A SDLC should result in a high quality system that meets or exceeds customer expectations, reaches completion within time and cost estimates, works effectively and efficiently in the current and planned information technology infrastructure, <sup>land</sup> is inexpensive to maintain and cost-effective to enhance. Computer systems have become more complex and often (especially with the advent of Service-Oriented Architecture) link multiple traditional systems potentially supplied by different software vendors.

To manage this level of complexity, a number of system development life cycle (SDLC) models have been created: "waterfall," "fountain," "spiral: "build and fix," "rapid prototyping," "incremental," and "synchronise and stabilise." Although the term SDLC can refer to various models, it typically denotes a waterfall methodology.' Readers wishing to learn details about these development models may consult the ISACA Technical Review Manual 2002 - 2009.

In project management a project has both a life cycle and a "systems development life cycle," during which a number of typical activities occur. The project life cycle (PLC) encompasses all the activities of the project, while the systems development life cycle focuses on realising the product requirements.

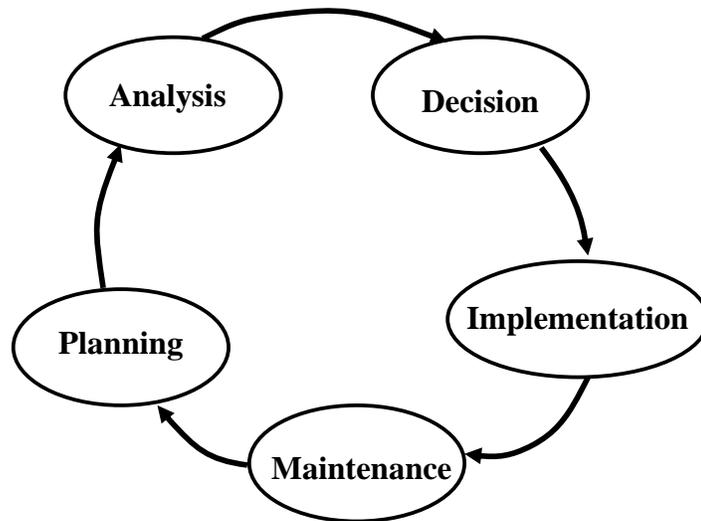
### **SELF-ASSESSMENT EXERCISE**

Highlight the auditors' role in systems development life cycle.

### **3.4 Systems Development Phases**

Systems Development Life Cycle (SDLC) adheres to important phases that are crucial for developers, such as planning, analysis, design, and implementation as depicted in figure 9.11 below. There are several Systems Development Cycle Models in existence.

The oldest model, which was originally regarded as "the Systems Development life Cycle," is the 'waterfall model': this is a sequence of stages in which the output of each stage becomes the input for the next. These stages generally follow the same basic steps but many different waterfall methodologies give the steps different names and the number of steps seems to vary between four and seven. There is no definitively correct Systems Development Life Cycle model, but the steps can be characterised and divided in several steps.



**Fig. 5.1** Systems Development Life Cycle (SDLC) Phases  
Analysis Design

### SELF-ASSESSMENT EXERCISE

Draw and label Systems Development Life Cycle (SDLC) Phases Analysis Design.

### 3.5 Auditors' Role in SDLC

In any SDLC project, the auditor is a subject-matter expert (SME) for risk and controls (what may go wrong on process and make recommendations to mitigate such risks). In such a circumstance, the auditor may play other roles such as found in the IT governance process, as follows:

- (a) Serving as a specialist in the SDLC Strategy Committee to offer advice on matters pertaining to controls;
- (b) The Auditor should be a member of the IT steering committee as key advisor;
- (c) The Auditor should ascertain the management framework for IT governance, e.g. COBIT, COSO;
- (d) He should get involved in the business plan development. The strategic alignment need makes this imperative; and
- (e) He should assess the maturity capability of the organisation with respect to IT governance and controls.

The Auditor should assess the performance measurement framework with respect to all SDLC projects using Balanced Score Card (BSC) approach.

## **4.0 CONCLUSION**

In this unit, we have discussed IT risk assurance methodologies and process, disaster recovery, networking (protocols and standards), communication risks.

## **5.0 SUMMARY**

Steps in quantitative risk analysis include assigning value to assets, estimating potential loss per threat, performing a threat analysis, deriving the overall loss potential per threat and reduce, transfer or accept the risk.

Recovery strategies include hot sites, cold sites, warm sites and rolling recovery sites.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. The qualitative method of Risk Analysis shows clear cut losses that can be accrued within one year. True/False
2. Discuss the system that addresses the question of business continuity, should the system fail.

## **7.0 REFERENCES/FURTHER READING**

Adeniyi, A. A. (2010). *Auditing and Assurance Services*. Lagos: Value Analysis Consult.

ICAN Study Pack. (2009). *Advance Audit and Assurance*. Lagos: VI Publishers.