ETICPA
THE WHEEL OF GOVERNANCE

The Ethiopian Institute of Certified Public Accountants

Accounting Technician Qualification for Ethiopia

ASSURANCE, CONTROL & ETHICS

MODULE 7

Textbook

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Contents

Introduction

This Textbook forms part of the suite of learning materials provided for those studying for the Accounting Technician Qualification for Ethiopia (ATQE). It is accompanied by a Question Bank for the module which you are studying, and these two resources should be used alongside each other.

Textbook

The Textbook provides concise yet comprehensive coverage of the learning outcomes included in the syllabus for this Module. The syllabus is presented on page v of this book, and each learning outcome is cross-referred to the chapter in which it is covered. You will also find that the start of each chapter explains the syllabus areas to be covered.

Within each chapter, you will find the topics are introduced and then explained in detail and illustrated with examples. There are short practice questions for you to assess what you have learned, with answers at the end of the chapter. Each chapter concludes with a summary of the topics covered, to help you consolidate them in your mind, and a short bank of self-test questions to test what you have learned. Therefore, you should read the learning material in the chapter, work through the examples and attempt the practice questions.

Using the Question Bank

As you complete each chapter of the Textbook you will be encouraged to attempt some of the practice questions relating to the chapter in the Question Bank. The questions in the Question Bank are presented in the same chapter order as the Textbook. Each chapter contains a bank of multiple choice questions (MCQs) and longer questions. The Question Bank is structured to correspond to the syllabus weightings for each topic.

The questions in the Question Bank are of exam standard, so attempting them will give you a good indication of whether you have fully understood the content of the Textbook chapter and are ready to attempt the exam. If you find the questions difficult and get the answers wrong, review the points made in the suggested answer and then go back to your own notes and the Textbook to make sure that you go through the subject again to ensure that you understand it.

Once you have worked through the whole Textbook and attempted the practice questions in the Question Bank as directed, there will still be questions remaining in the Question Bank which you have not yet attempted, which you can use when you are revising in the run-up to your exam.

Syllabus

Module 7: Assurance, Controls and Ethics

ISC Level 5

This module aims to explore the features of assurance, controls and ethics which are essential for the accounting technician. Assurance is a concept which is vital in both the private and public sectors. The syllabus explores the difference between audits and other assurance engagements. It covers aspects of internal control for a variety of transaction cycles and also includes detailed coverage of the importance of ethics for all accountants.

Main competency areas

On completion of this module, learners should be able to:

	Syllabus weighting
Explain the concept of assurance and why it is important in the financial and business environment and the public sector	10%
Explain and illustrate the importance of internal controls and how they may support an organisation in either the private or public sector	10%
Identify deficiencies in internal controls and make recommendations to remedy them	20%
Explain how to prevent and detect fraud in organisations	10%
Explain the importance of ethical behaviour for all professional accountants	20%
Understand the importance of corporate social responsibility (CSR) and sustainability for organisations	10%
Explain what is meant by corporate governance and define the key roles and responsibilities	10%
Explain the key differences relating to assurance, controls and corporate governance between the public and private sectors	10%
	100%

The syllabus weightings above show the relative weightings of topics within this subject and should guide the required study time spent on each. The marks available in the assessment will approximately equate to the weightings shown.

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1.2	Explain the concepts of agency and stewardship	1
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1.7	Explain the concept of the 'expectations gap' and outline ways in which it can be addressed	1
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2.2	Identify how errors and irregularities can be prevented or detected by control procedures	2
2.3	Identify the types of internal control used in the revenue (sales), purchases, payroll, inventory and capital expenditure functions and their suitability to different types of organisation and assess their effectiveness in a given situation	2

		Chapter number
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CHAPTER 1

The concept of assurance

Introduction

This chapter provides the foundation for this module. We shall be focussing on audit, as this is one of the most commonly-found forms of assurance, and the one you are most likely to encounter in your career, but will also explore other types of assurance engagement.

This chapter will need careful study if you are new to this topic. Some of the matters covered in this chapter will be expanded on later in this Textbook, and you are

advised to come back to this chapter after studying the whole Textbook. This will help you to consolidate your knowledge.

Throughout this Textbook you will find reference to International Standards on Auditing (ISAs). These standards form part of the framework that governs how audits are carried out, and they are issued by the International Auditing and Assurance Standards Board (IAASB). ISAs are intended primarily for the audit of commercial organisations, but they can also be applied to public sector entities.

The International Standards of Supreme Audit Institutions (ISSAIs) are international external audit standards for the public sector. They are issued by the International Organisation of Supreme Audit Institutions (INTOSAI) and are based on ISAs.

For the exam you are not required to know the regulatory framework in detail.

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
1.1	Define the concept of assurance and explain the difference between reasonable and limited levels of assurance
1.2	Explain the concepts of agency and stewardship
1.3	Identify the potential users of assurance reports, explain why users need such reports and outline the benefits of assurance
1.4	Define professional scepticism and explain why it is an important attribute of all accountants
1.5	Define professional judgement and explain how accountants exercise it
1.6	Explain and illustrate the concept of materiality
1.7	Explain the concept of the 'expectations gap' and outline ways in which it can be addressed

Exam awareness

Assurance is one of the key features of this module and will feature prominently in the examination. You should be able to define assurance and any associated terms and explain the importance of assurance in both the commercial and public sectors. Key topics such as professional scepticism and judgement are likely to appear in either multiple choice or longer questions.

1 What is assurance?

Introduction

This section will examine what we mean by assurance and will consider the parties involved in an assurance engagement.

Definition:
ASSURANCE

Assurance: a conclusion that gives users confidence in information contained within the subject matter produced by a responsible party.

Assurance reports produced by professional accountants can aid in enhancing confidence in an organisation. This confidence is good for anyone who has dealings with the organisation, and it also good for the economy as a whole. The availability of reliable information that has been independently assessed encourages investment and economic development. In the public sector such information demonstrates accountability, transparency and prudence in the use of public funds.

Before we go any further, attempt the practice question below. There is no right or wrong answer, but some suggestions are provided at the end of the chapter.

Practice question 1

You are considering buying a house and have asked a building surveyor to inspect the building before you finalise the purchase. Which factors would give you confidence in the results of the survey?

You will find the answer at the end of the chapter.

An assurance engagement for a professional accountant is a three-way relationship between:

- The responsible party
- The practitioner
- The users

In the case of a statutory audit of financial statements, the term **responsible party** refers to those responsible for producing the financial statements, that is the management of the entity. The responsible party is responsible for ensuring that the subject matter of the assurance engagement is accurate and complete. The **practitioner** is the accountant or firm that carries out the assurance engagement, and the **users** are the shareholders or owners of the company. The practitioner can be appointed by either the responsible party, the users, or both.

An assurance engagement will also involve:

- Subject matter – the information to be reviewed, for example financial statements
- Criteria – the benchmarks used to review the subject matter
- Evidence – sufficient and appropriate to reach a conclusion
- Report – to enhance the confidence of users in the subject matter

We can use the mnemonic **CERTS** to remember these elements:

- **C**riteria
- **E**vidence
- **R**eport
- **T**hree-way relationship
- **S**ubject matter

1.1. Types of assurance engagements

Statutory audits of the financial statements of private and public bodies are perhaps the most well-known assurance engagements. Professional accountants can also be involved with other types of assurance engagement, involving financial and non-financial subject matter, for example:

- Review of draft financial statements/business plans/financial projections, in support of an application to the bank for a loan or overdraft facility
- Evaluation of information systems to assess their reliability as a source of data
- Risk assessment to examine and evaluate financial and other risks relevant in the workplace
- Surveys of customer satisfaction to identify areas which may be damaging to the business and where improvements can be made
- Value for money, especially in the public sector (see Chapter 7) to assess whether resources of the organisation are being used economically, efficiently and effectively
- Investigating fraud to identify the circumstances and take steps to prevent a recurrence
- Reports on internal controls to identify whether they are appropriate and operate effectively
- Non-statutory audit, the term used for any situation where an audit is not required by law or regulations, so is voluntary, for example in support of an application for funding
- Environmental audit, a type of audit intended to assess environmental compliance and the nature and risk of any harm to human health and the environment

Assurance engagements may be required for organisations or activities that are regulated because they are in the public interest, for example:

- Bank audits
- Pension scheme audits

- Charity audits
- Lawyers' audits
- Clinical audits
- Personnel audits

Organisations can commission assurance on a voluntary basis, for example:

- Environmental audits (see Chapter 6)
- Due diligence for acquisition of another organisation
- Internal audit of processes and procedures
- Performance reviews

1.1.1. Audit engagement letter

The terms of audit and other assurance engagements will be set down formally in an engagement letter. This makes it clear what the assurance provider will do, depending on the nature of the engagement, so helps to manage the client's expectations. You don't need to know the content of an engagement letter in detail for the exam, and the precise content will vary depending on the purpose and intention of the engagement, so this abbreviated example of an audit engagement letter from ISA 210 is for illustration only.

Example 1.

To the management of XYZ Company:

The objective and scope of the audit

You have requested that we audit the financial statements of XYZ Company for the year ended 31 December 20X2. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists.

The responsibilities of the auditor

We will conduct our audit in accordance with ISAs and ethical requirements. We will exercise professional judgement and professional scepticism throughout the audit. We will also:

- Identify and assess the risks of material misstatements
- Design and perform audit procedures
- Obtain sufficient appropriate audit evidence

- Obtain an understanding of internal control
- Communicate any significant deficiencies in internal control

The responsibilities of management

Our audit will be conducted on the basis that management acknowledge and understand that they have responsibility:

- For the preparation of the financial statements in accordance with IFRSs
- For internal control
- To provide access to records, documents, and any additional information necessary for the audit
- To provide unrestricted access to persons from whom to obtain audit evidence
- To provide written confirmation concerning representations made to us in connection with the audit

Example 1.

We look forward to full cooperation from your staff during our audit.

Fee arrangements, billing and other information as required

Expected form and content of the auditor's report

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

Name of audit firm

Acknowledged and agreed on behalf of XYZ Company by

Signature

Name and title

Date

1.2. Types of organisation requiring audit or assurance

Here we shall take a moment to consider the types of organisation that might require the services of an assurance practitioner. The needs of organisations differ depending on their constitution, legal requirements and who is accountable to the users of accounts or any other reports or information they produce. In practice, all of these types of organisations are likely to require one or more of the types of audit or assurance services listed above.

Examples:

- Private and public limited liability companies
- Listed companies
- Sole traders
- Partnerships
- Charities
- Not-for-profit organisations
- Non-governmental organisations (NGOs)
- Public sector organisations
- Government ministries, departments and agencies
- Nationalised industries
- State-owned enterprises
- Clubs and societies

You will see from this list that all types of organisation can make use of assurance services, whether or not they are required by law or regulation to do so.

2 Levels of assurance

Introduction

The level of assurance provided by the practitioner will depend on the type of assurance engagement. Here we will consider the different levels of assurance and look at some examples.

An assurance engagement culminates in a report that provides either a **reasonable** level of assurance or a **limited** level of assurance. The level depends on the subject matter under review, the criteria used to carry out the engagement, and the type of evidence gathered and analysed.

2.1. Reasonable assurance

Definition: **REASONABLE ASSURANCE**

Reasonable assurance: this is a high level of assurance conveyed with a positive form of words.

This is the highest level of assurance possible and is expressed in the auditor's report on the financial statements. Note that this is not absolute assurance, ie a statement that the financial statements are 100% accurate; this would be impossible given the limitations of the audit process. Auditors do not review and verify every single one of the transactions that make up the amounts and

balances in the financial statements. The audit process will not detect all errors and misstatements because, as we shall see later in this textbook, audit procedures are based on risk assessment and sampling, which are designed to reduce the assurance engagement risk to an acceptably low level.

An audit of financial statements is a specific form of assurance and is often a statutory requirement for companies. Companies are legal entities incorporated according to companies acts or similar legislation, which varies from country to country.

The **positive form** of words is expressed as 'in our opinion the financial statements present fairly (or give a true and fair view) in all material respects the financial position of [the entity] and its financial performance and cash flows.'

Statutory audits of financial statements are conducted in accordance with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board. Note that ISAs do not override any local legislation in force in a particular country.

This example shows the key elements of an auditor's report produced in accordance with ISA 700. This is an abbreviated version of a 'clean' or 'unmodified' auditor's report, which means that the auditor has obtained sufficient appropriate audit evidence (see Chapter 3, Section 2.5) to conclude that the financial statements do not contain material misstatements (see Section 5 of this chapter). In this module you are not required to have a detailed knowledge of audit or assurance reports, but it is useful to see how all the elements of an assurance engagement come together.

Example 2.

Independent auditor's report

To the shareholders of XYZ Company

Opinion

We have audited the financial statements of XYZ Company for the year ended 31 December 20X2. In our opinion, the financial statements present fairly, in all material respects, [or give a true and fair view of] the financial position of the company as at 31 December 20X2, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). We are independent of the Company in accordance with ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of management for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and for the internal controls

necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

Auditor's responsibility for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Signature of the auditor/audit firm

Auditor address

Date

Example 2.

Practice question 2

In the auditor's report above, note or highlight the elements of an assurance engagement discussed in section 1 of this chapter. Hint: use the mnemonic CERTS to find the various elements.

You will find the answer at the end of the chapter.

Self-study 1.

Find out what the laws and regulations for company audits in your country are. The most likely are:

- Companies acts
- Stock exchange rules
- Regulations for listed/non-listed companies (quoted on a stock exchange)
- Regulations for banks and financial institutions
- Regulations for public interest entities
- Exemptions e.g. for small companies

2.2. Limited assurance

Definition: **LIMITED ASSURANCE**

Limited assurance: a lower level of assurance conveyed with a negative form of words.

Limited assurance is a lower level than reasonable assurance as it is based on a greater acceptance of risk and less rigorous procedures to obtain evidence. It is still meaningful and likely to enhance the users' confidence about the subject matter of the assurance engagement.

The **negative form** of words in a limited assurance report is expressed as 'nothing has come to my attention that indicates that [the subject matter] contains material misstatements.'

Guidance on assurance engagements other than audits of financial statements is provided by International Statement on Assurance Engagements (ISAE) 3000 *Assurance engagements other than audits or reviews of historical financial information.* It is a principles-based standard that can be applied to a broad range of assurance engagements and subject matters.

The assurance report is addressed to the users and should include the following items:

- Title of the report
- Addressed to the users
- Description of the subject matter
- Description of the criteria
- Clarification that the report is intended for the users and should not be used for any other purpose
- Identification of the responsible party
- Statement that the engagement was conducted in accordance with ISAE 3000
- Summary of the work performed
- Conclusion of the practitioner expressed in an appropriate form of words (positive/negative)
- Date of the assurance report
- Name of practitioner
- Signature of practitioner

Note the similarities with the audit engagement letter in Section 1 of this chapter.

The table below summarises the content of this section.

Table 1. Levels of assurance

Level of assurance	Form of words	Example
Reasonable	Positive	'In our opinion, the financial statements present fairly...'
Limited	Negative	'Nothing has come to my attention ...'

3 Agency, stewardship, and the users of assurance reports

Introduction

The nature of incorporated entities, such as limited companies, means that there is separation between the owners of the company (the shareholders) and those who are responsible for the strategy and operations (directors and management). In this section we will look at how assurance can reconcile these two parties and will consider the importance of accountability.

3.1. Agency and stewardship

In a small company it is perfectly possible and in fact normal for the owners to be responsible for the day-to-day running of the business, making strategic decisions and producing the financial statements. In larger companies, however, there is a separation between the owners and those who manage the business on their behalf. Stewardship and agency theories aim to define the relationship between the owners, or the principal party, and those that act on their behalf. You are not expected to study these theories in detail, but it will be useful here to define these two terms.

Definition: **STEWARDSHIP**

Stewardship: a fiduciary relationship between principal and steward, where the steward is responsible for the care and management of the principal's property.

Definition: **AGENCY**

Agency: an economic relationship where the agent has authority to act on behalf of the principal.

Agency theory recognises that conflict can arise where principals and agents have different goals and attitudes to risk. For example, the directors (agents) have the aim of increasing profits because their bonuses are based on a percentage of profits, whilst the principals (owners) are more concerned with exploring new markets.

The concept of stewardship recognises that directors have a duty of care towards the owners and are responsible for the safeguarding of the owners' property and reputation. They are held to account by the owners and are required to explain their decisions and their actions as stewards. This is known as **accountability**.

3.2. Accountability

The directors of a company must provide the owners, periodically, with an account of how well the business has performed and whether it is in a healthy financial condition. Annual financial statements give the owners this information in the form of a statement of profit or loss (performance) a statement of financial position

(end of year figures) and a statement of cash flows (use of funds). A statement of changes in equity is also produced which shows movements in capital and the year-end position. You will learn more about these documents in Module 5, Financial Accounting.

Stewardship and accountability apply to other types of organisation where there is a separation between ownership and management, such as the public sector, charities, clubs and societies.

3.3. The users of assurance reports

The users of assurance reports can be a specific, well-defined group, as is the case with the shareholders of a company. For public sector organisations potential users are much wider because accountability and fairness in the use of public money are of interest to taxpayers and society as a whole. Assurance reports have value to all who have dealings with organisations, such as potential investors, employees, customers and suppliers.

3.4. Benefits of assurance reports

Some organisations will elect to have an assurance engagement even if not required by law. The following are some of the benefits to users of assurance reports:

- Independent assessment of the stewardship role by a professional practitioner
- Financial statements that have been audited have more credibility because of the independent review of the auditor and are less likely to be misleading
- Scrutiny of management decisions
- Enhances confidence of users in the subject matter
- Conclusions are based on evidence
- Enhances confidence of banks, lenders and potential investors or donors
- Provides insight into the quality of accounting records, systems of internal control, IT systems and competence of staff
- Identify deficiencies in internal control
- Establishes trust between owners and management
- Economy as a whole benefits from reliable information
- Management are held accountable for their decisions and actions
- Acts as a deterrent against fraud and error
- For a growing company, getting used to the process will be a benefit if it becomes a statutory requirement in the future

3.5. Limitations of assurance reports

As we have seen in Section 2.1, assurance engagements can never provide absolute assurance because of the limitations inherent in the audit process. Audit evidence is persuasive rather than conclusive, and the auditor cannot reduce the risk of coming to the wrong conclusion to zero.

Here are some of the reasons for this under three headings relating to the nature of financial reporting, the nature of audit procedures, and considerations of timeliness, benefits and costs:

Financial Reporting:

- Management judgement is applied
- Decisions can be subjective
- Some amounts and balances, such as estimates, involve a degree of uncertainty
- There is an inherent level of variability in financial statements
- Accounting estimates form part of financial statements
- Future events can affect going concern, ie the ability of the company to continue trading
- Limitations of internal control systems: it may not be strong enough to prevent and detect errors

Audit procedures:

- Information provided to the auditor can be incomplete, either deliberately or not
- Fraud can be sophisticated and concealed through collusion
- The auditor is not trained to spot falsification such as forgery
- The auditor does not have legal powers to investigate wrongdoing
- Audit procedures are based on sampling, not 100% testing of every transaction
- Reliance is placed on controls in accounting systems
- The auditor's assessment of risk involves judgement
- Audit evidence is persuasive rather than conclusive
- The auditor is concerned primarily with material items, ie more significant items, discussed further in section 5

Timeliness, benefits and costs:

- Limited time and resources are available
- Assurance engagements take place after the events in the subject matter, i.e. they are based on historical information
- The value and relevance of information diminishes over time
- Balance has to be achieved between reliable information and the costs involved in obtaining it

Because of these limitations there can be resistance to compulsory assurance and audit when it is required by law or other regulation. Some of the reasons for this resistance are:

- Cost – the practitioner will charge a fee for assurance work
- Time-consuming – staff and management will need to provide information and to answer questions
- Limited value where there is no agency problem, for example in an owner-managed business
- Reputational damage – a possible consequence if the outcome is critical or less than positive

4 Professional scepticism and professional judgement

Introduction

Assurance engagements that demonstrate professional scepticism and professional judgement will enhance the confidence of users in the subject matter of the engagement. In this section we will look at what these terms mean.

4.1. Professional scepticism

Definition: **PROFESSIONAL SCEPTICISM**

Professional scepticism: having a questioning and critical mind, alert to the possibility of misstatement due to fraud or error.

Professional scepticism is a vital attribute of the professional accountant. It does not mean being suspicious or mistrustful of what the responsible party says or of the information that they produce. It simply means having an open and questioning mind and not accepting everything at face value. A professional accountant who demonstrates professional scepticism will gain the respect of clients by asking the right questions and showing that they understand how things can go wrong and how errors can occur.

Applying professional scepticism in an assurance engagement will help the auditor to be alert to:

- Audit evidence that contradicts other evidence obtained
- Information that casts doubt on the reliability of documents and responses
- Possible fraud
- Need to go beyond the requirements of ISAs with audit procedures
- Unusual circumstances
- Inappropriate assumptions and conclusions
- Scarcity of supporting evidence for material items

4.2. Professional judgement

Definition: **PROFESSIONAL JUDGEMENT**

Professional judgement: using experience, knowledge and training to make informed decisions within the context of auditing, accounting and ethical standards.

Professional judgement means applying relevant knowledge and experience when carrying out an engagement and includes:

- Considering materiality and risk
- Gathering audit evidence
- Evaluating audit evidence
- Evaluating management judgement

5 Materiality and the 'expectations gap'

Introduction

Materiality is an important concept in assurance and is a matter of professional judgement. For audit purposes a matter is material if its omission or misstatement could influence the economic decisions of the users of financial statements when they base their decisions on those financial statements. Materiality is a relevant factor in the 'expectations gap' discussed at the end of this section.

5.1. Materiality

Definition: **MATERIALITY**

Materiality: a concept applied to misstatements that could negatively influence the users of financial statements.

In an audit of financial statements, the auditor's opinion deals with the financial statements as a whole. As such the auditor is not responsible for detecting all potential errors that might have occurred in the preparation of those financial statements.

Materiality during an audit is a matter of professional judgement, which is affected by both the size and the nature of any potential misstatement.

Materiality should be considered at all stages of the audit:

- At the planning stage, when identifying and assessing the risks of material misstatements in the financial statements
- When designing procedures to obtain audit evidence
- When assessing the effects on the financial statements of misstatements that have not been corrected by management at the end of the audit

At the planning stage, the auditor will set materiality levels for the financial statements as a whole. There are different methods of doing this, and there is no one definitive approach. Typically, the auditor will calculate benchmarks based on key figures in the financial statements, for example:

- Between 5% and 10% of profit before tax
- Between 0.5% and 1% of revenue
- Between 1% and 2% of total assets

This means that, if the value of an item in the financial statements is more than 1% of revenue, the auditor will consider it material.

Other benchmarks will be more appropriate for non-profit making organisations or for owner-managed businesses. In an owner-managed business where the owner takes remuneration, it may be more appropriate to set profit before remuneration and tax as a benchmark.

Materiality will be reviewed throughout the audit and the benchmark figures will be adjusted if necessary.

Materiality is not only a quantitative measure that is determined solely by the size of the monetary amount of an item. Misstatements can be material for the users of financial statements because of their nature, for example:

- When disclosure is required by law or regulation, for example related party transactions and the remuneration of directors
- When disclosure relates to the industry, for example research and development costs are key amounts for pharmaceutical companies, and liquidity disclosures are important in financial institutions
- When separate disclosure is made in the financial statements, for example segments or business combinations
- When the circumstances of the entity are relevant, for example when a business combination has occurred during the accounting period
- When a new financial reporting framework has introduced new qualitative disclosures
- When an item that is not material by quantity changes a profit into a loss

In the case of public sector entities, items may be deemed material by law or regulation. For example, the misappropriation of small amounts of cash held on behalf of vulnerable residents of care facilities could be material because the duty of trust has been breached.

5.2. Performance materiality

Definition: **PERFORMANCE MATERIALITY**

Performance materiality: an amount set by the auditor at a lower level than materiality for the financial statements as a whole.

Materiality is a difficult concept to grasp, and performance materiality more so. Performance materiality is lower than materiality for the financial statements as a whole and is applied to classes of transactions and account balances. Consideration of performance materiality recognises that misstatements that are below the materiality level set for the financial statements as a whole can, when added together, amount to a material misstatement.

Example 3.

Performance materiality for revenue (sales) has been set at 2% of total revenue. Total revenue for the year is $100,000 so performance materiality is $2,000.

During the audit it was established that incorrect pricing had been applied to a batch of invoices, resulting in the following errors:

- Invoice X understated by $750
- Invoice Y understated by $900
- Invoice Z understated by $500

Although each understatement is below the materiality level of $2,000, when added together they amount to $2,150, which is above the materiality level for revenue.

As with materiality for the financial statements as a whole, performance materiality is a matter of professional judgement. This judgement is considered and applied to each individual assurance assignment, and is reviewed and adjusted as necessary as the assignment progresses.

5.3. 'Expectations gap'

The limitations discussed above contribute to the expectations gap, which is the difference between what the auditor actually does and the public perception of what a 'clean' audit report means (see Section 2.1 of this chapter). Here are some of the misconceptions that are frequently expressed, ie the public perception of what an auditor actually does:

- Audit is a legal requirement
- Audited accounts are 100% correct in all respects
- All transactions are tested by the auditor
- All mistakes have been corrected by the auditor

- Auditors investigate and detect fraud
- The organisation will continue operating in the long term
- Auditors prepare the financial statements
- Auditors provide absolute assurance

The reality is:

- Audit is not always a legal requirement; it depends on the jurisdiction and there can be exemptions for small companies
- Auditors can only conclude that the financial statements are free of material misstatements
- Auditors test samples and concentrate on material items
- It is the responsibility of management to correct errors in the financial statements
- Management are responsible for preventing and detecting fraud (although the presence of audit, whether external or internal, can be a deterrent)
- It is management's responsibility to ensure that the company is a going concern
- Financial statements are prepared by the management of a company
- Auditors can provide only reasonable assurance

Note that the points above apply primarily to the private sector; in the public sector the remit of audit can include a statutory duty to detect fraud. Assurance in the public sector is discussed in more detail in Chapter 7.

Attempts have been made in recent years by standard setters to close this expectations gap. The format and content of the auditor's report have been enhanced and additional information such as Key Audit Matters and considerations of going concern have been included. Assurance providers can help to close this gap by clarifying the work that will be carried out and explaining the limitations of the work that they carry out to reach their conclusions.

Further developments are possible due to technology such as auditors' use of data analytics, which use the power of computers to scrutinise accounting systems and to enable 100% testing of transactions. We shall be looking at the use of computers in auditing in Chapter 3. For the time being, however, ISAs assume that the audit opinion is based on testing samples.

It can be argued that the gap is widening because of the many scandals involving corporate wrongdoing and audit failure that have emerged in recent years. In many African countries there is a perception that the audit process is not proving to be effective.

Self-study 2.

- Were you aware of the expectations gap?
- Has your perception of what auditors actually do changed after reading this chapter?
- How would you explain the purpose and nature of audit to colleagues who are not professional accountants?

Practice question 3

Which of the following are limitations of assurance reports?

1. They are addressed to the owners of a company, not management.
2. Audit evidence is persuasive rather than conclusive.
3. Audit evidence is based on sampling.
4. They are based on historical information.

A. 1 and 4 only

B. 2 and 3 only

C. 1, 2 and 3 only

D. 2, 3 and 4 only

You will find the answer at the end of the chapter.

Chapter Summary

You should now be able to:

- Define the concept of assurance
- Explain the difference between reasonable and limited assurance
- List the elements of an assurance engagement
- Define agency and stewardship in the context of assurance
- Explain the importance of professional scepticism and professional judgement and how they are applied
- Define materiality
- Explain what is meant by the term 'expectations gap'

Please check your learning by attempting the self-test questions below

Self-test questions

1. What are the two levels of assurance?
2. A statutory audit of financial statements is an example of a limited assurance engagement. Is this statement TRUE or FALSE?
3. What are the five elements of an assurance engagement?
4. What is the 'expectations gap'?
5. An auditor who is alert to the possibility of fraud is demonstrating which attribute?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 1.1 to 1.8
- Questions 2 and 3

Answers to practice questions

Answer to Practice Question 1

Here are some of the points you could have made:

- The building surveyor is independent of the seller
- The surveyor is a member of a recognised professional body
- The surveyor has relevant expertise and experience
- The report will be in writing

- The report will be available in good time
- Appropriate criteria will be used in the survey
- Is anything not included (for example safety of electrics)

Well done if you noted five or more points.

Answer to Practice Question 2

- Independent auditor's report (**R**eport)
- To the shareholders (**T**hree-way relationship (users, responsible party, practitioner)) of [X Company]
- Report on the audit of financial statements (**S**ubject matter)
- Opinion – present fairly, in all material respects/true and fair view (reasonable assurance – positive form of words)
- Basis for opinion – conducted according to ISAs and ethical requirements (**C**riteria), sufficient appropriate audit evidence (**E**vidence)
- Responsibilities of management (**T**hree-way relationship (users, responsible party, practitioner)) – prepare financial statements
- Auditor's (**T**hree-way relationship (users, responsible party, practitioner)) responsibilities – obtain reasonable assurance and issue report

Answer to Practice Question 3

The correct answer is D. 1 is a benefit as the report is independent of management.

CHAPTER 2

Internal controls

Introduction

The management of an organisation are responsible for the day-to-day operations and processes that help to ensure that the organisation meets its objectives. Internal controls are an integral part of these processes, and they cover both financial and non-financial activities.

Understanding the system of internal control is an essential part of planning and risk assessment in order to identify where errors and misstatements are likely to occur. The auditor of financial statements will concentrate on those key controls

that are relevant to the financial statements, but other controls, including non-financial ones, will be significant in other assurance engagements.

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
2.1	Explain the purpose of internal controls and their role in mitigating risks
2.2	Identify how errors and irregularities can be prevented or detected by control procedures
2.3	Identify the types of internal control used in the revenue (sales), purchases, payroll, inventory and capital expenditure functions, their suitability to different types of organisation and assess their effectiveness in a given situation
2.4	Identify the types of internal control over expenditure in public sector entities
2.5	Explain the role of general IT internal controls and information processing controls and state examples of each
2.6	Explain the potential limitations of a system of internal controls
2.7	Identify factors relating to the operating environment and internal control system that may influence control risk
2.8	Explain the role of internal audit in a system of internal control in the private and public sectors

Exam awareness

Exam questions on internal controls can focus on identifying key controls, identifying deficiencies or designing tests of control. You could be presented with a scenario in a longer written question or this could be tested in the MCQ section of the exam.

1 Internal control and risk

Introduction

Auditors of financial statements must be aware of the risk that there could be material misstatements that have occurred because of fraud or error. When assessing the risk, the auditor needs to understand various factors about the entity being audited, including the system of internal control.

Definition: **SYSTEM OF INTERNAL CONTROL**

System of internal control: the system designed and maintained by the management of an organisation to provide reasonable assurance that financial reporting is reliable.

The management of an organisation is responsible for designing the system of internal control, for monitoring its effectiveness and for making improvements where necessary.

The system of internal control has five components:

- Control environment
- Risk assessment process
- Process to monitor the system of internal control
- Information system and communication
- Control activities

In this chapter we shall be concentrating primarily of the last of these components, the controls that have been put in place by management and that are relevant to the audit of financial statements. An evaluation of internal control is an important aspect of measuring audit risk.

Definition: **AUDIT RISK**

Audit risk: the risk that the auditor comes to an inappropriate conclusion when there are material misstatements in the financial statements.

Audit risk is different from the business risks that the entity faces. It refers to the risk that the audit opinion in the auditor's report could be incorrect.

Definition: **BUSINESS RISK**

Business risks, on the other hand, are those that have an adverse effect on an organisation's ability to achieve its objectives. There should be risk assessment processes in place to identify and respond to the business risks facing the organisation.

- Financial risks – credit and interest risk (unable to repay debt), going concern (business is not viable in the long term), overtrading (expanding too quickly)
- Operational risks – losing customers, losing key staff, running out of stock, natural disaster, pandemics
- Compliance risks – breaches of laws and regulations, penalties and litigation

Auditors need to be aware of business risks in so far as they can have an impact on the financial statements. Awareness of the business risks that are faced by the audit client can also help the auditor understand the business and the industry in which it operates. Business risks should not, however, be confused with audit risk.

Audit risk, from the definition above can be summarised as the risk that the auditor gets it all wrong. For example, the auditor could issue a 'clean' or unqualified auditor's report when the financial statements are, in fact, materially misstated. Alternatively, an adverse audit opinion could be issued when there are no material errors or misstatements in the financial statements. The potential consequences to the auditor of getting it wrong include:

- Damage to the reputation of the firm
- Loss of the audit client
- Loss of other clients
- Sanctions from the auditor's regulatory body
- Financial penalties

ISA 200 identifies two aspects of audit risk. The first relates to the entity itself and is made up of inherent risk and control risk. Together these make up the risk that the entity's system of internal control fails to identify and correct material misstatements that are present in the financial statements. The second aspect relates to the auditor and the risk that audit procedures will fail to detect material misstatements.

This can be expressed as a formula:

Audit risk = Inherent risk x Control risk x Detection risk

We shall now look at each of these components in more detail.

1.1. Inherent risk

This is the risk that an item in the financial statements could be materially misstated, either on its own or in combination with other misstatements, before any relevant controls are taken into account. Characteristics that can affect inherent risk include complexity, the importance of the item relative to the financial statements, uncertainty or the subjectivity that comes with accounting estimates.

Here are some examples of inherent risks that the auditor will consider and assess with the aid of professional judgement:

- Large volumes of cash transactions
- Complex regulations affecting the sector in which the audit client operates
- Complex financing arrangements
- Operations in countries with unstable economies or unstable currencies
- Volatile or uncertain markets

- Going concern issues including the loss of significant customers
- Changes in the industry or in supply chains
- Developing new products or services or moving into new markets
- Geographical expansion
- Changes in key personnel
- New environmental legislation
- Complex accounting processes
- Risk of non-compliance with financial reporting standards
- Reorganisation or restructuring of the business
- New IT systems
- Investigations by regulatory bodies
- Pending litigation (legal action)
- Significant transactions with related parties
- Significant numbers of unusual or non-routine transactions
- Performance-related pressures on management
- Opportunities for fraud

1.2. Control risk

This is the risk that the controls that are put in place by management fail to prevent, detect or correct a material misstatement in the financial statements.

Taken together, inherent risk and control risk are the two components of the risk of material misstatements before the audit has taken place.

When evaluating control risk the auditor will take into account the following factors:

- The policies and procedures the organisation has in place
- Experience, training and competence of client staff
- Active role of management in the control environment
- Control activities within the system of internal controls (authorisation and approval, reconciliations, verifications, physical or logical, segregation of duties, all discussed further below)

1.3. Detection risk

This is the only element of the audit risk formula that is under the auditor's control. It is the risk that audit procedures will fail to detect material misstatements in the financial statements. The auditor must design and carry out audit procedures to reduce audit risk to an acceptably low level.

There are two aspects to detection risk:

1. Sampling risk – this is based on the fact that auditors do not normally test 100% of a population of transactions or balances
2. Non-sampling risk – this is the risk that the auditor comes to the wrong conclusion for any reason other than sampling risk

Non-sampling risk is affected by the experience of the audit team and how they approach the work. The risk is higher if the audit team is new or where there is a reliance on junior staff. Examples of non-sampling risk include: using inappropriate audit procedures, misinterpreting audit evidence, and failing to recognise a misstatement.

Where inherent and control risk are high, the auditor will attempt to reduce detection risk to an acceptably low level by:

- Planning the audit work and designing appropriate audit procedures
- Using experienced staff
- Applying professional scepticism
- Supervising the work of junior audit staff
- Monitoring and reviewing audit work performed
- Adapting the audit approach to changing circumstances

2 Types of internal control

Introduction

In this section we shall look at some of the ways in which we can classify the internal controls that the management of an organisation can put in place. We shall also consider some of the limitations of internal controls.

2.1. Internal controls by function

Internal controls can be classified according to the function that they are designed to perform in addressing control risk:

Table 1. Internal controls by function

Function	Description	Example
Prevention	Designed to prevent an error occurring in the first place	Physical controls, such as locks or keypads, over access to restricted areas

Table 1. Internal controls by function

Function	Description	Example
Detection	Designed to detect errors after they have occurred	Reconciling the bank ledger account to the bank statement at the end of the month
Correction	Designed to recover losses or correct undesirable outcomes	Disciplinary action taken against employees found guilty of misconduct
Direction	Designed to provide guidance to avoid an unwanted outcome	Manuals and training provided to staff

Now try the following practice question to test your understanding of functional controls. This is not a financial statements example but it serves to demonstrate how controls are applied.

Practice question 1

You are driving your car in an area that has a restricted speed limit. What controls would you expect to see?

You will find the answer at the end of the chapter.

2.2. Internal controls by type

Another way of classifying controls is provided by ISA 315. 'Control activities' is one component of the system of internal control. Control activities can be manual or automated, and include the following:

Table 2. Internal controls by type

Type	Description	Example
Authorisation and approvals	Confirm that a transaction is valid by a higher level of management	▣ Expenses reviewed and approved by supervisor ▣ Invoice cost checked automatically to purchase order

Table 2. Internal controls by type

Type	Description	Example
Reconciliations	Compare two or more data elements and take action if there are any differences	▣ Reconcile the sales ledger balances to the balance on the sales ledger control account ▣ Reconcile the balance on the bank ledger account to the balance on the bank statement
Verifications	Compare two or more items with each other or one item with policy	▣ Compare purchase order items to price list
Physical or logical controls	Address the security of assets	▣ Secure facilities for assets or records ▣ Hierarchy of password access to computer applications and data files ▣ Cash counts ▣ Inventory counts
Segregation of duties	Assign responsibility for authorising transactions, recording transactions, and custody of assets to different members of staff	▣ Authorising credit sales is separated from maintaining accounts receivable and handling cash receipts ▣ Sales staff cannot amend price files or commission rates

2.3. Limitations of internal controls

Even the most effective system of internal control cannot guarantee absolute assurance because of the inherent limitations of internal controls. Here are some of the reasons for this:

- Human error – mistakes can be made if individuals do not understand how a control works or if the system fails to pick up discrepancies
- Collusion – two or more people can bypass controls or they can be overridden by management

- Unusual transaction – systems are designed for everyday events and may not be capable of dealing with something out of the ordinary
- Management judgement – the cost of having certain controls might be too high for the level of risk involved, for example employing enough staff to ensure segregation of duties
- Controls not operated properly – deliberately or because of lack of training
- Controls being circumvented or ignored – deliberately or because they are too difficult or impractical
- No management review – to check that controls are operating consistently and effectively
- Staff incentive – no action taken if staff fail to implement the controls in place
- Overreliance on controls – this can lead to complacency especially with regard to computerised controls where the assumption is that the computer cannot be wrong

2.4. 'SOAPSPAM'

Before we move on to considering controls for specific items in the financial statements, here is a useful mnemonic to prompt you to think of the types of control activities you would expect to find in an accounting system: SOAPSPAM.

- **S**egregation of duties – more than one person is involved at different stages in a process to minimise the risk of fraud and error
- **O**rganisation – the structure of the business and reporting lines
- **A**uthorisation – transactions are approved by senior managers, changes to standing data can be made by authorised persons only
- **P**hysical – security over assets and accounting records
- **S**upervision – oversight of personnel performing accounting tasks
- **P**ersonnel – the right people for the accounting team are recruited and trained
- **A**ccounting – arithmetic checks on the processing of transactions
- **M**anagement – overall review of activity in the accounting system

3 Controls for specific items in the financial statements

Introduction

When producing the financial statements, management make a number of assertions about transactions and balances in the financial statements and about how they are presented in accordance with the appropriate reporting framework.

Auditors use these assertions when considering where misstatements are likely to occur. In this section we shall consider these assertions before looking in more detail at controls that are appropriate for specific items in the financial statements, namely sales, purchases, payroll, inventory, and capital expenditure.

3.1. Financial statement assertions

Definition:
ASSERTIONS

Assertions: representations made by management that the financial statements have been prepared in accordance with the applicable financial reporting framework.

In other words, when producing the financial statements management are saying that the assertions are inherently present in the transactions, balances and presentation of the figures in those statements. The auditor uses these assertions to identify where potential misstatements could occur. ISA 315 divides the assertions into two categories which we will now consider.

3.2. Assertions about classes of transactions and events, and related disclosures, for the period under audit

These assertions relate to items in the statement of profit or loss.

- Occurrence – recorded transactions have occurred and pertain to the entity
- Completeness – all transactions and related disclosures that should have been recorded have been recorded
- Accuracy – amounts have been measured and disclosed appropriately
- Cut-off – transactions have been recorded in the correct accounting period
- Classification – transactions have been included in the correct accounts
- Presentation – transactions have been aggregated or disaggregated and disclosed appropriately

3.3. Assertions about account balances, and related disclosures, at the period end

These assertions relate to items in the statement of financial position or the balance sheet.

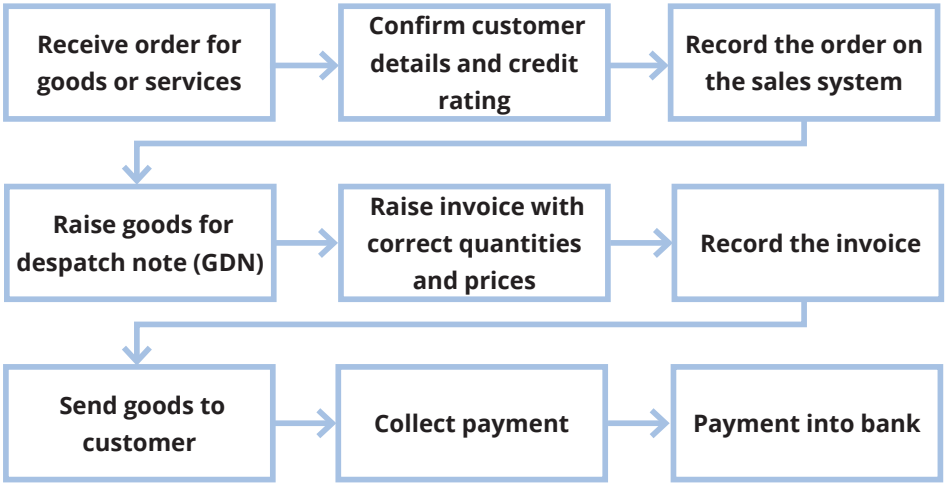
- Existence – assets, liabilities and equity interests exist
- Rights and obligations – assets and liabilities belong to the entity
- Completeness – all assets, liabilities and equity interests have been recorded in the financial statements
- Accuracy, valuation and allocation – amounts and valuations are recorded and disclosed appropriately
- Classification – assets, liabilities and equity interests have been recorded in the appropriate accounts
- Presentation - transactions have been aggregated or disaggregated and disclosed appropriately

The meanings of these assertions should become clearer when we consider them in the context of items in the financial statements.

3.4. Revenue (sales)

The main steps in the system for recording revenue can be summarised as follows:

Figure 1. Main steps in the system for recording revenue



Examples of some of the documents referred to are included in the Appendix at the end of this chapter.

Within this system we would expect to see controls applied at the various stages of the process. The control objective in each case is the link between the assertion and the control in that it states what the control is intended to achieve with respect to

the assertion. Sales of goods and services are recorded as revenue in the statement of profit or loss, and outstanding amounts from customers at the end of the accounting period are represented by the receivables balance in the statement of financial position.

Table 3. Controls applied to recording revenue

Assertion	Control objective	Control
Occurrence	To ensure that all sales transactions recorded have occurred and that they relate to the entity	▣ Segregation of duties between taking sales orders, recording sales and receiving payment from the customer ▣ Sales order forms are pre-numbered and sequential ▣ Orders are checked to inventory before they are confirmed with the customer ▣ Goods despatched note (GDN) is raised
Occurrence	To ensure that sales are made only to credit-worthy customers	▣ New credit customers are accepted only after credit references have been obtained ▣ Senior staff determine credit ratings ▣ Credit ratings are regularly reviewed ▣ Sales orders are checked to customer credit limits before orders are accepted
Completeness	To ensure that all goods despatched have been invoiced	▣ Sales orders are matched to GDNs and sales invoice ▣ Sales invoice is sent out with goods despatched ▣ Customer signs GDN on receipt of goods

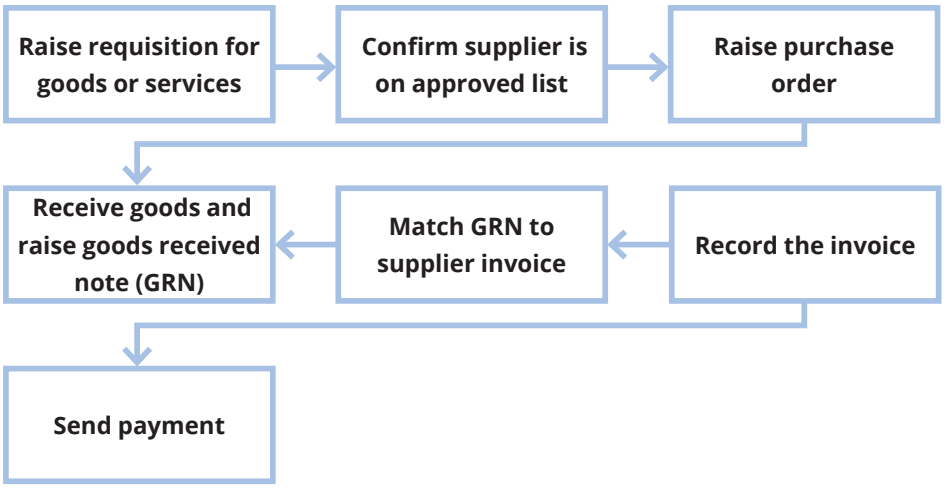
Table 3. Controls applied to recording revenue

Assertion	Control objective	Control
Completeness	To ensure that all monies due from customers have been received	▣ Receipts are matched to outstanding sales invoices ▣ Receipts are banked promptly ▣ Regular reconciliation of receivables ledger control accounts ▣ Aged debtor analysis ▣ Credit control procedures ▣ Regular statements are sent to customers with outstanding balances
Cut-off	To ensure that all sales transactions have been recorded in the correct accounting period	▣ Sales invoices are recorded promptly

3.5. Purchases

The main steps in the system for recording purchases can be summarised as follows:

Figure 2. Main steps in the system for recording purchases



Purchases of goods and services are recorded as either cost of sales or expenses (depending on the nature of the purchase) in the statement of profit or loss, and outstanding amounts due to suppliers at the end of the accounting period are represented by the payables balance in the statement of financial position.

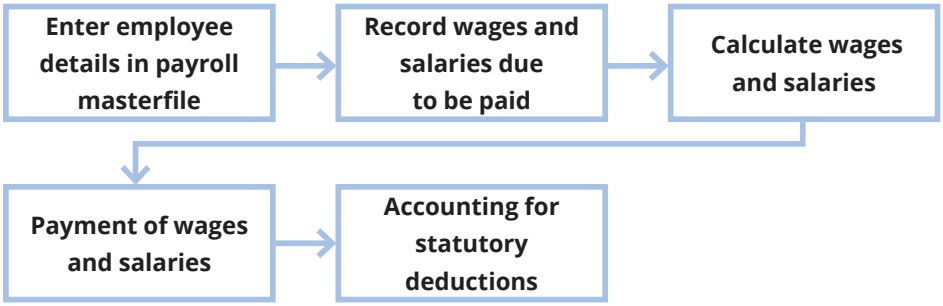
Table 4. Controls applied to recording purchases

Assertion	Control objective	Control
Occurrence	To ensure that all purchases transactions that have been recorded have occurred and that they relate to the entity	▣ Segregation of duties between placing orders, recording the purchase and making payment to suppliers ▣ All purchases are authorised by a senior budget holder ▣ Purchase orders are held securely ▣ Goods received are checked against purchase orders ▣ Purchase orders are matched to GRNs
Completeness	To ensure that all purchases transactions have been recorded	▣ Purchase orders and GRNs are matched to suppliers' invoices ▣ Suppliers' statements are reconciled to the trade payables balance ▣ Regular reconciliation of purchase ledger control accounts
Completeness	To ensure that all payments are for goods and services actually received	▣ Payments are made to approved suppliers only ▣ Payments are made against authorised invoices only
Cut-off	To ensure that all purchases are recorded in the correct accounting period	▣ Purchase invoices are recorded promptly

3.6. Payroll

These are the main stages in a payroll system:

Figure 3. Main steps in the payroll system



Wages and salaries are typically paid weekly or monthly, either in cash or by bank transfer.

Table 5. Controls applied to payroll

Assertion	Control objective	Control
Occurrence	To ensure that payment of wages and salaries is made to genuine employees only	▣ Segregation of duties between payroll staff and the personnel or human resources department ▣ All employees have a unique staff reference number and a personnel file ▣ Policies and procedures are in place for recruitment of staff ▣ Starters and leavers are recorded promptly ▣ Personnel and payroll masterfiles are password protected

Table 5. Controls applied to payroll

Assertion	Control objective	Control
Completeness	To ensure that all employees are paid for work actually done	▣ All employee time is recorded through clocking in or timesheets ▣ Monthly payroll totals are agreed to departmental budgets ▣ Departmental managers agree payroll to staff lists ▣ Payroll is checked and authorised before releasing funds ▣ Employees paid in cash sign to confirm receipt of correct amount
Accuracy	To ensure that payroll costs are recorded accurately	▣ Payroll masterfile is reconciled to the general ledger account
Accuracy	To ensure that statutory and other deductions are calculated accurately	▣ Management perform sample checks of payslips to confirm accuracy of calculations ▣ Access to masterfile is password protected
Cut-off	To ensure that payroll costs are recorded in the correct accounting period	▣ Personnel procedures to inform the payroll department promptly of starters, leavers, and any changes in pay rates

3.7. Inventory

In the financial statements inventory is often a high-value amount. Inventory items can be valuable and are therefore vulnerable to theft. Controls over inventory include physical controls and regular counts of inventory items.

Table 6. Controls applied to inventory

Assertion	Control objective	Control
Existence	To ensure that all inventory in the statement of financial position exists	▣ Access to inventory is restricted ▣ Segregation of duties between those maintaining inventory records and those responsible for the physical security of inventory ▣ Inventory is counted on a regular basis ▣ Inventory records are reconciled to the ledger account
Completeness	To ensure that all movements of inventory are recorded	▣ All goods in are accompanied by a GRN ▣ All GRNs are recorded on the inventory system ▣ All goods out are accompanied by a GDN ▣ All GDNs are recorded on the inventory system
Accuracy	To ensure that inventory quantities and values are recorded accurately	▣ Inventory counts are matched to inventory records ▣ Regular review of inventory to identify obsolete or damaged items
Cut-off	To ensure that inventory movements are recorded in the correct accounting period	▣ GRNs and GDNs are processed daily ▣ Inventory records are reconciled to the ledger account

3.8. Capital expenditure

Capital expenditure, for example for the purchase of non-current assets, forms part of the statement of financial position. It is important that controls are in place to distinguish this type of expenditure from trade purchases and expenses, which have an impact on profit.

Table 7. Controls applied to capital expenditure

Assertion	Control objective	Control
Completeness	To ensure that all capital expenditure is authorised	▣ A budget exists for capital expenditure ▣ Capital expenditure is authorised by senior management ▣ Authorisation limits are in place for capital expenditure ▣ Requisitions are matched to the capital budget
Completeness	To ensure that all capital expenditure is correctly recorded	▣ Non-current assets are recorded in the non-current asset register ▣ The register is reconciled to the general ledger ▣ Physical counting of non-current assets is carried out on a regular basis
Classification	To ensure that all capital expenditure is distinguished from revenue expenditure	▣ Requisitions for capital expenditure indicate the correct general ledger account ▣ Capital purchases are matched to the budget

3.9. Internal controls over public sector expenditure

Public sector organisations face similar risks to the private sector, for example the risk of errors in the financial statements and fraud. Other risks are more relevant for organisations that receive funding rather than generating income with a view to making a profit. Expenditure controls are particularly important for organisations whose purpose is to spend or allocate funds on public services that are provided for the benefit of citizens and society as a whole.

Before undertaking any expenditure the following must be considered:

- Expenditure is permitted by law
- Funds exist

- Budget is approved
- Prices have been agreed with suppliers
- Authority levels are in place for placing orders and approving payments
- Special approval is required for unusual or emergency payments

Controls must be in place to ensure that expenditure is:

- Necessary
- Authorised
- Within budget
- Represents value for money
- Within legal powers
- Only made to approved suppliers

Public sector organisations might have statutory or other obligations to control and monitor expenditure, for examples specific terms and conditions relating to government grants. In some jurisdictions internal audit functions and audit committees have a role in scrutinising public expenditure. Internal controls in the public sector are discussed in more detail in Chapter 7, Section 4.

4 IT controls

Introduction

Most organisations, large and small, will use computerised systems and automated processes to some extent. In this section we look at the two main categories of IT controls: general controls that apply to the computerised system as a whole, and controls designed for specific applications in information processing.

4.1. General IT controls

General IT controls support the whole information system and all the applications within it. These include:

- Database controls – to prevent unauthorised access and unauthorised amendments
- Operating system controls – to control the process of adding new users, changing existing users' access rights, and virus/malware protection
- Network controls – to control remote access, web-based applications and third-party access

- Development controls – over the design, testing, installation and documentation of new systems and the training of staff
- Continuity controls – regular maintenance, back-up procedures, physical protection of equipment, emergency and disaster recovery procedures

4.2. Application controls

Application controls are integral to specific programs and processes. They are designed to prevent errors in the first place and to detect them if they do occur.

Input controls – to ensure the completeness, integrity and accuracy of data input

- Input verified to output
- Program checks such as check digits, character checks and permitted range
- Authorisation via password access and authorisation levels

Processing controls – to ensure that programs are operating effectively

- Batch reconciliations
- Screen warnings to prevent logging out before process is completed

Output controls – to ensure the completeness and accuracy of output

- Output verified to input
- Manual reconciliation
- Controls over masterfiles and standing data

External auditors will identify those controls that are significant to the financial statements. For other types of assurance such as that provided by internal audit, other controls will be relevant.

Auditors will test IT controls by designing appropriate audit procedures. We shall be looking at testing controls in more detail in Chapter 3, including the use of Computer Assisted Audit Techniques (CAATs).

Practice question 2

Design a control that would prevent unauthorised changes to standing data in a computerised system.

You will find the answer at the end of the chapter.

5 Internal audit

Introduction

In this section we shall consider the role of internal audit in the public and private sectors and look at the types of assignment that internal auditors can carry out.

5.1. Internal audit in the private sector

Internal audit is a part of the organisation that contributes to management and forms part of the system of internal control. Internal audit provides assurance on systems and processes and therefore has a wider scope than external audit.

The table below is a summary of the main differences between external audit and internal audit; it will be useful to bear this in mind as we look at internal audit in more detail.

Table 8. Main differences between external and internal audit

External audit	Internal audit
▣ Independent of the organisation	▣ Employees of the organisation
▣ Appointed by shareholders (or equivalent)	▣ Appointed by management
▣ Report addressed to shareholders	▣ Report addressed internally
▣ Focus on financial statements	▣ Wider scope of work including providing assurance on internal controls
▣ Normally performed annually	▣ On-going function
▣ Statutory requirement	
▣ Regulated by ISAs	

Definition: **INTERNAL AUDIT**

Internal audit: independent and objective assurance designed to add value and improve an organisation's operations.

Internal auditors should apply ethical principles and should comply with ISAs or other standards when carrying out their duties. Although independence is arguably harder for internal audit, it is still an important consideration and the organisation should have structures in place that protect the independence of the internal audit function. Independence is impaired if internal audit have any role in decision-making or management, for example preparing the management accounts. This can create a conflict of interest when reporting on possible deficiencies within their own organisation.

Independence is discussed in more detail in Chapter 5. It is important for all auditors to be able to demonstrate that they are independent of management, and that they are able to provide an objective and impartial view. The ability to report directly to the board of directors (or equivalent) enhances the independence of the internal audit function.

Good corporate governance arrangements, which we shall study in Chapter 6, recommend that private companies have in place an internal audit function that reports to the audit committee.

5.2. Internal audit in the public sector

Internal audit is often a statutory or regulatory requirement in public sector organisations. The scope of work can include:

- Regularity – transactions and activities are within the legal powers of the organisation
- Propriety – transactions are right and proper and are ethically sound
- Authority – internal rules and regulations are followed at all times
- Value for money – resources are used with economy, efficiency and effectiveness

Self-study 1.

What are the requirements for internal audit in your country?

- Private sector
- Public sector

5.3. Internal audit assignments

Internal audit assignments can include:

- Value for money audits, to assess the economy, efficiency and effectiveness of the organisation's operations
- Testing internal controls, including IT controls, to assess whether they operate efficiently and are appropriate for the circumstances
- Fraud investigations, to identify how a fraud has happened and take measures to prevent a recurrence
- Contract audits, to assess and verify the terms of a new contract the organisation is entering, for example the financial and resourcing requirements of a large scale construction contract
- Compliance with laws and regulations, sometimes required for particular types of organisation, such as banks or insurance companies

- Operational audits, to evaluate an organisation's operating activities, by examining its processes, systems and procedures
- Performance audits, to determine for public sector entities in particular whether functions or processes are working as intended to achieve stated goals
- Financial audits, validating financial data used internally or presented externally
- Customer service reviews, to identify the effectiveness of operations and scope for improvement

5.4. Using the work of internal audit

Internal auditors frequently carry out the same type of work as external auditors, for example testing internal controls. It would make sense therefore for external auditors to rely on some of this work to avoid duplication of effort and to save time and cost for the audit client. Before deciding to do so, the external auditor should consider the nature and scope of the work of internal audit, and the independence of the function within the organisation.

Guidance on using the work of internal audit is provided by ISA 610 *Using the work of internal auditors.* External auditors should apply the following criteria to determine whether they can use the work of internal audit:

- The status of internal audit, their policies and work procedures, and who they report to will determine the independence and objectivity of the internal audit function
- The qualifications and training of internal audit staff and the resources allocated to the function will help in establishing the professional competence of internal audit staff
- The arrangements for planning, documenting, and reviewing the work of internal audit will establish whether internal audit have a systematic and disciplined approach to their work

5.5. Provision of internal audit services

Despite the name, internal audit services do not have to be provided internally. There are different options available for organisations that have or are planning on having an internal audit function.

The advantages and disadvantages of each option are summarised below the description.

5.5.1. Internally within the organisation (in-house)

- Internal audit staff are employees of the organisation
- The internal audit function can be part of the finance department or it can be part of another department such as central corporate services
- Internal audit assignments will be based within the organisation only

Table 9. Advantages and disadvantages of internal audit services

Advantages	Disadvantages
▣ Internal audit staff have knowledge of the organisation ▣ Good working relationships ▣ Confidentiality is protected ▣ Commitment to the organisation and its objectives	▣ Full independence is difficult to maintain ▣ Range of skills and experience could be limited ▣ Costs of recruitment and training ▣ Limited career progression for internal audit staff

5.5.2. Outsourced

- Internal audit functions are provided by an external organisation
- This can be an accountancy firm or a specialist internal audit provider
- Internal audit staff are employees of the internal audit services provider
- The services provided and the cost are determined by the terms of the contract between the organisation and the provider of internal audit services

Table 10. Advantages and disadvantages of outsourced audit services

Advantages	Disadvantages
▣ Independent from the organisation ▣ Larger pool of staff ▣ Staff gain knowledge and experienced from a variety of clients ▣ Wider technical expertise	▣ Costs to the organisation can be higher than in-house ▣ Contracts must be precisely worded ▣ Contract performance must be monitored ▣ Less continuity of staff and commitment to the organisation

5.5.3. Consortium arrangements

- A number of organisations form a consortium to share an internal audit service
- The internal audit service is provided by one member of the consortium, known as the host organisation
- Internal audit staff are employed by the host organisation
- This is an option for small organisations who do not wish to or who cannot afford to have a full internal audit function in-house

Table 11. Advantages and disadvantages of consortium arrangements

Advantages	Disadvantages
▣ Sharing good practice amongst member organisations ▣ Member organisations pay only for those services that they require ▣ Independence is maintained ▣ Economically viable	▣ Increased administration costs ▣ Disputes over allocation of staff to various members of the consortium

Organisations sometimes opt for some combination of these arrangements. For example, an organisation could maintain a core internal audit function in-house and bring in specialists as and when needed. This approach is known as 'right-sourcing', literally 'choosing the correct source'. It has become more popular in recent years as outsourcing generally has become more attractive to organisations. For example, a company may have one division which engages in specialist contracts, but most of its business is routine. A right sourcing approach could see the company outsource its internal audit function generally, but for the specialist division it could join with other companies with a similar business in a consortium for internal audit activities relating to that area of operations.

Practice question 3

List the THREE main options for the provision of an internal audit service and give a brief description of each one.

Practice question 4

What is the meaning of the financial statement assertion 'cut-off'?

You will find the answer at the end of the chapter.

Chapter summary

You should now be able to:

- Define audit risk and differentiate audit risk from business risk
- Describe internal controls
- Identify control activities
- Identify financial statement assertions
- Design internal controls for specific items in the financial statements
- Describe general and application IT controls
- Describe the role of internal audit

Please check your learning by attempting the self-test questions below.

Self-test questions

1. Which of the following is NOT a component of an entity's system of internal control?

   A. The control environment

   B. The risk management process

   C. The assurance engagement team

   D. Monitoring the system

2. Which of the following are limitations of internal control?

   1. Human error in operating a control
   2. Business risks facing the organisation
   3. Collusion between two or more members of staff

   A. 1 and 2 only

   B. 1 and 3 only

   C. 2 and 3 only

   D. 1, 2 and 3

3. Which of the following is a control activity?

   A. Segregation of duties

   B. Organisational structure

   C. Human resources

   D. Changes to the accounting system

Self-test questions

4. Which of the following is an appropriate internal control over handling and counting cash?

   A. IT password control to cash recording system

   B. Authorisation of cash amounts held on the premises

   C. Approval of management for counting cash on the premises

   D. Two members of staff involved in the counting process

5. Where an organisation has an internal audit function, it is always appointed by and reports to the shareholders. Is this statement TRUE or FALSE?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 4.1 to 4.8
- Questions 5 and 6

Answers to practice questions

Answer to Practice Question 1

- Prevention – speed bumps to limit the speed of the car
- Detection – speed cameras, registration plate recognition
- Correction – fines or other penalties imposed by law enforcement authorities
- Direction – road signs clearly showing the speed limit

Answer to Practice Question 2

- Access to system is password protected
- Authorisation for changing standing data is limited to management
- Separate password access to standing data
- Password is not written down
- Log-out reminder
- System-generated reports of changes to standing data reviewed independently (this would also detect unauthorised changes or security breaches)

Answer to Practice Question 3

Option 1 – in-house

- Internal audit staff are employees of the organisation
- The internal audit function can be part of the finance department or it can be part of another department such as central corporate services
- Internal audit assignments will be based within the organisation only

Option 2 – outsourced

- Internal audit functions are provided by an external organisation
- This can be an accountancy firm or a specialist internal audit provider
- Internal audit staff are employees of the internal audit services provider
- The services provided and the cost are determined by the terms of the contract between the organisation and the provider of internal audit services

Option 3 – consortium arrangements

- A number of organisations form a consortium to share an internal audit service
- The internal audit service is provided by one member of the consortium, known as the host organisation
- Internal audit staff are employed by the host organisation
- This is an option for small organisations who do not wish to or who cannot afford to have a full internal audit function in-house

Answer to Practice Question 4

Cut-off, when applied correctly, ensures that transactions are recorded in the correct accounting period.

Appendix. Sample documents

This Appendix includes examples of some of the typical business documents referred to in this chapter.

Sales order

Customer Name:
Customer Ref:
Delivery address:

Order No.
Date:

Description of goods	Quantity	Unit price $	Total $
		Order total:	**$**

Invoice

From: Dodoma Co
To: Customer

Invoice no.
Invoice date:
Order no.
Order date:

Description of goods	Quantity	Unit price $	Total $
		Shipping:	**$**
		Invoice total:	**$**

Payment details:
Account name:
Sort code:
A/c no:

Payment terms: 30 days from invoice date

Goods recieved note

GRN No:

Supplier name: **Delivered by:**

Date: **Signature:**

No	Goods	Ordered quantity	Delivered quantity

Received by: **Checked by:**

CHAPTER 3

Deficiencies in internal controls and remedies

Introduction

This chapter will focus on how auditors and other assurance professionals document the financial systems and internal controls of their clients. Various methods are available to them, and we shall consider the merits of each one.

Then we shall consider how auditors obtain the evidence they need in order to reach a conclusion. Testing controls is an important part of this evidence-gathering. Where deficiencies in internal control are identified, there are proper ways of reporting these findings.

Finally in this chapter we shall look at the reasons why changes sometimes have to be made to accounting systems, and how those changes are implemented.

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
3.1	Use systems records such as flowcharts, systems notes, internal control questionnaires and internal control evaluation questionnaires to record and evaluate systems of internal control
2.9	Explain the importance of testing controls and outline the ways in which auditors and other assurance professionals test controls
3.2	Identify and report deficiencies in internal controls in sales, purchases, payroll, inventory, and capital expenditure
3.2	Identify possible changes to the accounting systems and their implications for the organisation
3.4	Make justified recommendations for changes to the accounting system
3.5	Identify the potential impact of changes on users of the accounting systems, such as changes to working practices and required support
3.6	Quantify the costs of recommendations and carry out cost-benefit analysis of proposed changes

Exam awareness

Controls are a key element of this syllabus and your knowledge can be tested in MCQs. The topic is very likely to be examined in a written question as well, possibly with a scenario that you will have to read and understand before you attempt a question that tests your understanding and your ability to pick out relevant information.

A typical question on controls could ask you to identify deficiencies in a client's system of internal control and then to make recommendations to remedy the deficiencies. This requires a professional approach to demonstrate your understanding of controls from Chapter 2 and to show that you can make appropriate recommendations.

Deficiencies in the system of internal control is one reason for making changes to the system, and you could be asked a written question of either 10 or 15 marks on the process of making changes to the accounting system.

1 Recording systems of internal controls

Introduction

When considering the risks of material misstatements in the financial statements, auditors will need to assess how good the client's systems are at minimising control risk. Auditors of financial statements will be concerned with those controls that are relevant, such as those within the accounting system. Other assurance providers may be interested in other controls, such as those relevant to monitoring performance.

Information about internal controls is available from a number of sources. If this is a regular audit, there will be notes on file from previous years. The client company will have staff manuals and other documentation relating to controls that can be used as reference. It is still necessary for the auditor to document the system in order to assess the adequacy of controls and to identify where misstatements could occur. Even if this was done the previous year the notes must be reviewed to ensure that they are up to date and that they reflect the current system in place. The systems notes will be useful later in the audit when it is time to design audit procedures to test the controls.

The auditor will obtain the information necessary for documenting the system from talking to relevant client staff and observing them as they show controls in action where appropriate.

There are three main techniques available for recording the system of internal control and we shall now look at each of these in turn. At the end of the section we shall comment on the advantages and disadvantages of each method.

1.1. Narrative notes

These are simply notes that describe the system and the steps within the process represented by the system under review. Where necessary comments can be added or areas can be highlighted where potential deficiencies could occur. Narrative notes are good for simple systems and do not require a high level of expertise to complete. See the example below.

Example 1.

Client name: X Co **Date:**

Purchases system notes **Initials:**

1. Purchase orders are pre-numbered
2. Receive purchase order
3. Purchase order authorised by heads of department [obtain list of authorised staff]
4. Supplier checked to approved list [is this up to date?]

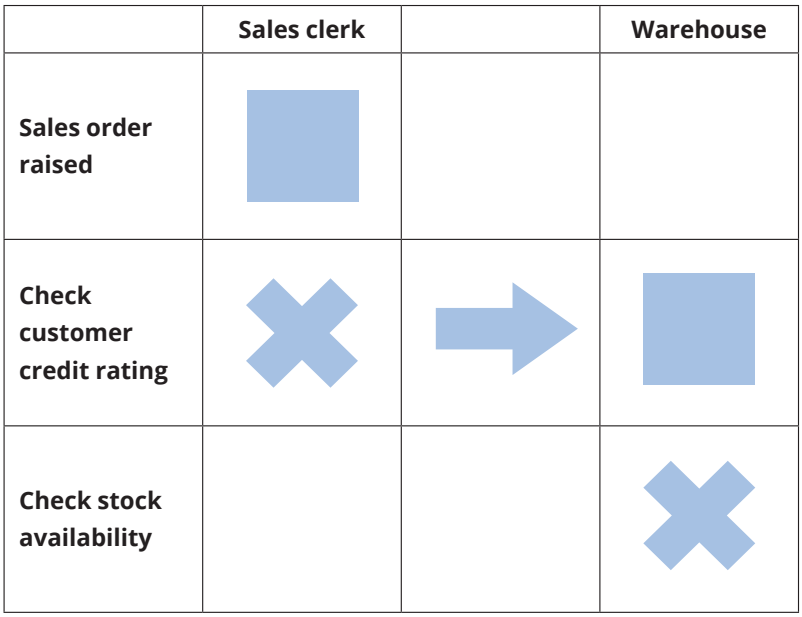
Etc.

1.2. Flowcharts or diagrams

These are graphic representations of a system, using symbols and directional lines to illustrate how information passes through the system and the various processes that take place. They can be harder to understand than narrative notes and need some knowledge of the conventions and symbols used in order to put them together. For complex systems, especially integrated computerised systems, some form of graphical representation will be essential in order to understand the various processes and how they interact with one another.

See Figure 1 for a simple example of how part of a flowchart could look. The 'X' symbol indicates a control that is applied to a document, in this case a sales order (the square icon), as it passes through the various stages in the sales system. The arrow shows movement from one part of the system to another.

Figure 1. Example of a flowchart



1.3. Checklists and questionnaires

These can be a straightforward list of questions in the form of a checklist that requires a 'yes' or a 'no' answer or they can focus on identifying where deficiencies could occur. Below are simple examples: the first an extract from a checklist and the second an extract from a questionnaire.

Example 2.

Client name: Bekele Co **Date:**

Purchases system checklist **Initials:**

1. Are goods received from suppliers checked to make sure they are the correct quantities and quality and received in good condition? **Yes/No**
2. Are goods received checked to purchase delivery notes? **Yes/No**
3. Are goods received checked to purchase invoices? **Yes/No**

Etc.

Example 3.

Client name: Bekele Co **Date:**

Purchases system questionnaire **Initials:**

1. How do you ensure that:
   - Goods cannot be ordered from a supplier not on the approved list?
   - Purchase invoices are not paid unless goods have been delivered?

Etc.

Below is a summary of the advantages and disadvantages of each method.

Table 1. Advantages and disadvantages of ways to record the system of internal control

Narrative notes	Flowcharts/diagrams	Checklists/ questionnaires
Advantages ▣ Easy to prepare ▣ Easy to understand ▣ Easy to update ▣ Can be prepared by junior auditors ▣ Good for simple systems **Disadvantages** ▣ Not suitable for complex systems ▣ May not spot potential deficiencies ▣ Can be time-consuming	**Advantages** ▣ Good for complex systems ▣ Standard format ▣ Ensures all flows are covered ▣ Can highlight deficiencies **Disadvantages** ▣ Some expertise/ training needed ▣ Not suitable for non-standard systems or unusual transactions ▣ Difficult to update	**Advantages** ▣ Ensure that all controls are covered ▣ Quick and easy to complete ▣ Identify key controls ▣ Flexible ▣ Highlight potential deficiencies **Disadvantages** ▣ Over-reliance on ticking boxes ▣ Important questions could be missing

2 Testing controls

Introduction

In this section we shall consider how the auditor tests the controls that have been identified in the client's accounting systems in order to determine how effectively they are operating in practice. The auditor will not, however, rely on tests of control alone. ISA 330 does not permit this, for reasons that we shall consider in Section 2.3. Substantive tests of transactions and account balances will also need to be completed. Finally in this section we shall look at how computers and the power of big data can be used as an audit tool.

2.1. Walk through test

Once the systems documentation is complete, the auditor will confirm that they understand the system by doing a walk-though test. This involves tracing a small number of transactions through the system as documented. An example would be tracing a customer order through the system from when the order is received from the customer to when the amount due is remitted and banked. Any misunderstandings can be clarified at this stage before audit procedures can be designed for testing the controls within the system.

2.2. Tests of controls

The purpose of testing controls is to confirm that controls are operating effectively and consistently in preventing, detecting and correcting material misstatements. The auditor is concerned with those controls that have a potentially material effect on the financial statements.

The auditor will use one or more of the following approaches for testing controls in the client's system:

- Inspection
- Observation
- Reperformance
- Inquiry

Let's look at these procedures in more detail.

Inspection – this involves examining records and documents, for example for evidence of authorisation. The nature and the source of the records and documents will affect how reliable the auditor considers them to be.

Observation – the auditor looks at a process or procedure being performed, for example the client's staff carrying out an inventory count. This provides evidence

that the process or procedure is being performed. There are limitations to using observation to gather evidence; the presence of the auditor can influence behaviour, and the evidence is valid only at the point in time when it is observed.

Reperformance – the auditor carries out a control independently. For example, the auditor performs the bank reconciliation and compares it with management's version of the same control.

Inquiry – this involves obtaining information by asking questions of persons within and outside the organisation. Evidence obtained through enquiry is normally used to corroborate other evidence. It can also contradict other evidence, for example a response to an inquiry can raise the possibility of management override of controls.

Example 4. Tests of controls

Inspection

- Sales invoices are in a numerical sequence
- Documents have been authorised by an appropriate person
- Credit limits are in place and are applied
- There is a list of approved suppliers for purchases

Observation

- Segregation of duties is in place throughout the sales and purchases cycles
- Physical controls are in place
- Staff use passwords to access systems
- No unauthorised access is granted
- Cash is held securely
- Segregation of duties during the inventory count

Reperformance

- Bank reconciliation
- Receivables control account reconciliation
- Payables control account reconciliation
- Sample inventory counts to compare with client records

Inquiry

- Policies and procedures are in place and staff understand them

Now try the following practice question.

Practice question 1

What type of control would the auditor be able to observe? Are there any limitations to evidence obtained in this way?

You will find the answer at the end of the chapter.

2.3. Substantive tests

Substantive tests, or tests of detail, must be performed regardless of whether the auditor can place reliance on internal controls. ISA 330 is very clear on this, and the reasons given are:

- The auditor's assessment of risk is a matter of judgement
- All risks may not have been identified
- The inherent limitations of internal control, including management override

Tests of control provide indirect evidence whereas substantive tests provide direct evidence. Substantive tests link directly to the assertions in the financial statements that we looked at in Chapter 2.

The auditor will use one or more of the following approaches for performing substantive tests:

- **Analytical procedures** – this refers to a specific substantive procedure that involves the analysis of relationships in data, both financial and non-financial. Inconsistencies and fluctuations are examined and investigated.
- **Tests of detail** of transactions and balances:
  - **Inspection** - inspection of physical assets provides evidence of their existence and their condition, which can affect the valuation
  - **External confirmation** – evidence obtained by the auditor from a third party, used to confirm assertions relating to account balance
  - **Recalculation** – the auditor checks the arithmetical accuracy of calculations

If you are asked to propose substantive tests in the exam, make sure that you explain exactly what the procedure involves, and avoid vague words such as 'check'.

In some circumstances the client's system of internal controls might be so weak that the auditor concludes that no reliance can be placed on controls. In this situation there is no purpose to carrying out tests of controls, and the auditor will rely solely on substantive testing to gather audit evidence.

Example 5. Substantive tests

- Inspect a sample of motor vehicles and vouch (ie match) the details to the non-current assets register.
- Select a sample of sales invoices and vouch the details (quantities, price, customer etc) to the sales order.
- Select a sample of purchase orders and trace the supplier details to the list of approved suppliers.
- Compare supplier statements to payables balances and investigate any discrepancies.
- Recalculate aged receivables.
- Analyse payroll costs by month and note any fluctuations.

2.4. Audit evidence

The purpose of audit procedures is to obtain evidence. The auditor needs to:

- Understand the organisation and identify the risk of material misstatement in the financial statements
- Test the effectiveness of controls in preventing, detecting and correcting material misstatements
- Carry out substantive procedures to detect misstatements

The evidence obtained by the auditor must be sufficient and appropriate (ISA 500). '**Sufficient**' relates to the **quantity of evidence**. This will be determined by the auditor's professional judgement in response to their assessment of the risk of material misstatement. Enough evidence must be gathered to support the auditor's opinion in the auditor's report.

'**Appropriate**' means that the evidence must be **relevant and reliable**. Relevant evidence will relate directly to the assertion being tested. The reliability of evidence is determined by the quality of the evidence and the source of the evidence. There are some key rules on reliability of evidence:

- Evidence obtained from independent external sources is more reliable than evidence obtained from the audit client's records
- Original documents are more reliable than photocopies
- Written evidence is more reliable than oral because it cannot be altered or denied
- Evidence obtained from the client is more reliable if the client's system of internal control is effective
- Evidence generated by the auditor is more reliable than information obtained directly from the client

2.5. CAATs and data analytics

Most business that are subject to audit will use computerised systems for some if not all of their accounting needs. Auditors too have adapted their audit techniques to include the use of computers in their work.

Definition:
COMPUTER ASSISTED AUDIT TECHNIQUES (CAATS)

Computer Assisted Audit Techniques (CAATs): audit procedures performed by the auditor using computers as an audit tool.

There are two main types of CAATs: audit software and test data.

Table 2. CAATs comparison

Audit software	Test data
▣ Used primarily for **substantive tests** of transactions and balances ▣ Software is installed on the auditor's computer and is used to perform checks on an audit client's data ▣ Client data is copied onto the auditor's computer ▣ Checks can now be performed automatically instead of manually	▣ Used primarily to test **controls** ▣ Suitable for larger audit engagements ▣ Tests are performed on the client's systems ▣ Requires the consent and co-operation of the audit client
Examples	
Using spreadsheet functions to ▣ Sort data e.g. by monetary value ▣ Stratify populations for sampling ▣ Search for specific items in order to flag them for review ▣ Perform calculations eg ratios ▣ Reperform calculations e.g. casting the sales day book ▣ Perform analytical procedures Using specialised software designed for audit use; various packages are available for this purpose Using customised software developed by the audit firm for specific needs or specific clients	Test data – data is fed into the client's system to check whether a control is operating effectively. The data may be valid, to produce a positive outcome, or 'dummy' data can be input to see whether it is rejected. For example, if the system only accepts dates in the format DD/MM/YYYY entering 18/8/22 would be rejected as invalid. Embedded or integrated test facilities – installed on the client's system throughout the accounting period to monitor how the system is working on a continuous basis.

There are advantages and disadvantages of using CAATs:

Table 3. Advantages and disadvantages of CAATs

Advantages	Disadvantages
▣ Time-consuming manual calculations can be performed more efficiently ▣ Auditors can test more items quickly ▣ Large volumes of data can be manipulated and analysed ▣ Auditors can concentrate or more complex tasks ▣ Can be used by competent junior staff ▣ Demonstrates professionalism to the client	▣ Costs of software packages ▣ Staff may need training ▣ Risk of corrupting client systems ▣ Risks of working with live data ▣ Relies on the quality of the data ▣ Experience needed to interpret the results of testing

Data analytics are a step up from CAATs, a development that has come about as a result of 'big data' and the increasing processing power of computer systems. Auditors can now test 100% of data populations and can manipulate that data in innovative ways that can add value to the audit process. The science of data analytics is constantly evolving and has the potential to have a profound effect on how audits are conducted in the future.

In computerised systems, test data can be used to test controls. The auditor enters data into the client's system and compares the output with the expected results of the control.

Example 6.

The auditor has documented the sales system and one of the controls over customer orders states that customer orders of $10,000 or above must be referred to the finance manager for a credit check before the order is input.

The auditor enters test data in the form of a sales order with a value of over $10,000. If the order is accepted the control has failed to operate. If the order is rejected the auditor can conclude that the control is operating as documented.

3 Reporting deficiencies in internal control

Introduction

During an audit of financial statements, the auditor might find that there are weaknesses, or deficiencies, in the internal controls that they have documented and tested. This section discusses what should be done in this situation.

3.1. Deficiencies in internal control

Deficiencies in internal control can exist when:

- A control is poorly designed or it is performed in such a way that it fails to prevent, detect and correct misstatements in the financial statements, or
- A control that should be in place is missing from the system of internal control

Misstatements may be material because of their size or their nature. Misstatements that, by themselves might be trivial, can become material when they are added together.

The auditor must apply professional judgement when considering whether reliance can continue to be placed on the client's system of internal control, or whether more extensive substantive procedures need to be performed.

3.2. Reporting deficiencies in internal control

Deficiencies in internal control must be reported to management. Management, not the auditor, are responsible for making any corrections necessary to the financial statements, and for putting in place improvements to the system of internal controls.

Significant deficiencies in internal control must be reported to those charged with governance. When deciding whether a deficiency is significant the auditor will consider the following:

- The amounts affected by the deficiency
- The potential risk of material misstatement as a result of the deficiency
- The likelihood of material misstatements resulting from the deficiency
- The risk of fraud
- Volume of activity
- How important the control is to the financial reporting process
- The cause and the frequency of deficiencies
- How any deficiencies identified relate to other controls in the system

3.3. Recommendations for improvement

Although not a requirement in an audit of financial statements, the terms of an assurance engagement could require the assurance provider to make recommendations for improvement when deficiencies in internal controls have been identified. Internal auditors will also make recommendations following a review of controls in an organisation.

Practice question 2

In a sales system, the sales clerk sets the credit limits for customers and also checks the credit rating for each customer before recording the sales order onto the system.

Identify a deficiency in this system and the potential risks arising, and make recommendations to address the deficiency.

You will find the answer at the end of the chapter.

When making recommendations you will draw on your knowledge of financial statement assertions, control objectives and the types of control that are appropriate for the main items in the financial statements. You should also think about the risks of material misstatements that arise as a result of deficiencies in internal controls.

Recommendations can be made in a management letter. This is addressed to the board of an organisation and it informs them of weaknesses and deficiencies in the internal control system identified during the audit.

The following is an example of how deficiencies are reported:

Table 4. Examples of how deficiencies are reported

Audit finding	Risk	Audit recommendation	Management response
There are variances between the non-current asset register and the general ledger non-current asset ledger account	Assets could be misappropriated. The financial statements could be misstated	The non-current asset register should be reconciled to the general ledger on a regular basis and any discrepancies investigated and resolved	This was a temporary situation during the switchover to a new asset register
Staff expense claims are not being authorised prior to payment and are not always accompanied by valid receipts.	Staff could claim for inappropriate items. Fictitious claims could be paid	All expenses incurred by staff should be accompanied by valid receipts and should be checked and authorised before being passed to finance for payment.	Updated expenses policy has been distributed to all staff

Where necessary an action plan, agreed between the auditor and management, will be put in place to rectify the deficiencies identified. Progress can then be assessed during a follow-up visit or another appropriate method of monitoring the action plan.

4 Changes to accounting systems

Introduction

From time to time management will decide to make changes to the accounting systems of an organisation. In this section we shall look at the accounting function and systems, the reasons for making changes and how those changes are implemented.

4.1. The accounting function

The purpose of the accounting function of an organisation is to:

- Accurately record all accounting transactions
- Produce accurate and useful reports suitable for the needs of various users
- Provide an audit trail that documents the use of the organisation's resources through to the outcomes of using those resources

Internal users need information to plan, control and manage performance, and to make executive decisions. Internal reporting includes:

- Monthly management accounts
- Budgets and budget monitoring reports
- Costing of products and margins
- Inventory control
- Staff costs

External reporting includes:

- Financial statements
- Statutory returns such as tax
- Payroll deductions
- Corporate reporting

Internal reporting is not regulated and is designed to meet the needs of the organisation. External reporting, on the other hand, is regulated by laws and regulations such as International Financial Reporting Standards (IFRSs). So it is possible that a change to the accounting system may be required due to a change in an IFRS, for example a change in the way information has to be presented.

Corporate reports provide an entity to communicate with shareholders and wider stakeholders. They provide financial and non-financial information about historical performance (for example in the financial statements) and about future plans,

strategies and prospects (for example in the directors' report). There is increasing public demand for reporting on the environmental impact of an entity's activities, and the development of international standards for sustainability reporting mean that information systems will need to provide the necessary data.

4.2. Accounting systems

Accounting systems are designed to produce information from:

- Accounting transactions
- Raw financial data
- Input from users
- Management adjustments (journals, estimates and provisions)

The design of the accounting system is determined by:

- The size of the organisation
- The structure of the organisation
- Costs of the system, staff training, software updates and back-up facilities
- The number of sites connected to the system

A good accounting system should have the following attributes:

- Reliable – consistently produce accurate information with back-up to protect against loss of data
- Timely – information is produced when it is needed, both internally and externally
- Controlled and secure – access is protected by physical controls, passwords, and supervision of staff
- Documented – system documentation and user manuals for reference, training, updating and in the event of system breakdown
- Monitored – IT controls are effective and are regularly reviewed by management

4.3. Changes to the accounting system

Changes to the accounting system will be required from time to time. The following is a summary of the reasons for making changes to the accounting system.

Table 5. Reasons for making changes to the accounting system

Reason	Indications
Company is growing	▣ Staff multitasking because of lack of segregation of duties will no longer be acceptable ▣ More controls needed to reduce risk ▣ New staff will mean a larger payroll ▣ Recognition of separation between ownership and management ▣ Capacity for increase in transactions ▣ Meet requirements of laws and regulations ▣ More layers of control
Deficiencies identified by auditors, staff or through efficiency review	▣ Controls are not effective ▣ Duplication of processes ▣ Redundant processes ▣ Poor value for money has been identified
Changes in personnel	▣ Staff turnover is high ▣ Recruitment of more staff to meet increased demand ▣ Merging or splitting up departments
Changes in the company's strategic objectives	▣ Acquisitions, mergers or takeovers ▣ Entering new markets ▣ Discontinuing products or operations
Developments in technology	▣ Responding to threats of cyber attacks ▣ Replacement of obsolete systems ▣ Software that is no longer supported ▣ E-commerce ▣ Use of hand-held devices
Cost considerations	▣ Cost reductions ▣ Budgetary constraints ▣ Development costs for new products

Table 5. Reasons for making changes to the accounting system

Reason	Indications
Regular monitoring	▣ Efficiencies identified ▣ Improvements to systems recently installed ▣ Changes to timing/frequency of processes ▣ Changes to authorisation levels ▣ Increased automation of processes ▣ Addressing problems identified by staff
Changes in the legal or regulatory environment	▣ Changes to financial reporting standards ▣ Disclosure requirements ▣ Online reporting to tax authorities ▣ Money laundering regulations ▣ Environmental issues

4.4. Cost/benefit analysis

Before making any changes to the accounting system, the organisation will carry out a cost/benefit analysis to identify the costs of the new system and the benefits it will bring to the organisation. Costs and benefits can be tangible or intangible in nature. The result can affect the decision as to whether to go ahead or not.

Tangible costs are those that can be quantified in monetary terms:

- Purchasing the new system
- Installation
- Staff training
- Software licences
- Running costs and maintenance
- Off-site back-up facilities
- Add-ons and patches
- Updates and upgrades

Intangible costs are the effects of changes that cannot be quantified in monetary terms. Management must assess the potential impact of these changes as part of the cost/benefit analysis.

Practice question 3

Can you think of any intangible costs or negative impacts on the organisation of implementing a new accounting system?

You will find the answer at the end of the chapter.

Some intangible costs can include:

- Staff dissatisfaction if not consulted
- Staff resistance to change
- Loss of customers if the system is slow when first installed
- Damage to reputation if customer service is impaired
- More errors occurring when the new system is unfamiliar

Intangible costs can be mitigated with proper planning, training, leadership and communication with staff and customers.

Part of the communication process should include the tangible and intangible benefits of the new system, for example:

- Improvements in efficiency of operations
- Increase in profits
- Staff morale improves as they gain experience using the new system
- Decrease in workload for staff through efficiencies
- Automation reduces need for dull, repetitive manual tasks
- Better customer experience
- Reputation for good service is enhanced

4.5. Making the changes

Changes to the system can be made using a variety of approaches:

- Wholesale change – replace one system with another, for example from paper-based to computerised. It is always wise to carry out a pilot run of the new system to identify any problems in the new system before it goes live and before the old system is archived or made obsolete
- Phased change – step by step changes. This takes longer but there is more control over the process
- Parallel running– both systems run alongside one another for a period of time until the new system finally takes over. This is cumbersome and costly and doubles the effort involved. It does, however, enable problems to be identified and resolved

Whichever method is chosen, it must contain the following elements so that the process runs smoothly and the transition is successful:

- Planning – time, cost, stages, contingency plans
- Communication – with staff, customers, stakeholders and users
- Testing – test data used to test the new system and compare results with the old
- Monitoring – to ensure improvements have been achieved and any unforeseen problems are addressed promptly

Practice question 4

What are the main disadvantages of using CAATs in an audit?

You will find the answer at the end of the chapter.

Chapter Summary

You should now be able to:

- Record systems of internal control using narrative notes, diagrams and questionnaires
- Design audit procedures to test internal controls
- Identify and design simple substantive procedures
- Describe the use of CAATs
- Identify deficiencies in internal controls and make recommendations for improvements
- Understand why changes to accounting systems are sometimes necessary
- Identify options for making changes to the accounting systems

Please check your understanding by attempting the self-test questions below.

Self-test questions

1. What does the audit procedure of reperformance involve?
2. Recalculation can be used as a test of control. Is this TRUE or FALSE?
3. Auditors of financial statements can rely solely on tests of control to gather audit evidence. Is this TRUE or FALSE?
4. Which of the following are substantive procedures?
    1. Inspection
    2. Analytical procedures
5. What is the difference between a tangible cost and an intangible cost in making changes to accounting systems?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 7.1 to 7.16
- Questions 8 and 9

Answers to practice questions

Answer to Practice Question 1

What type of control would the auditor be able to observe?

Physical controls:

- Locked doors
- Key pad access
- Security staff

Access controls

- Security passes being shown for access to buildings
- Password needed to access computer systems (auditor tries and fails to gain access)

Are there any limitations to evidence obtained in this way?

- Control observed at a moment in time only
- Presence of the auditor influences behaviour

Answer to Practice Question 2

Deficiency: The sales clerk sets the credit limits for customers. If limits are set too high there is a risk that customers will not be able to pay and the debt will be irrecoverable.

Recommendations: Credit limits should be set by the sales manager or another senior member of the sales team. This establishes segregation of duties between setting the limit and checking an individual customer's limit before processing the order. Credit limits should be reviewed on a regular basis.

Answer to Practice Question 3

Some intangible costs are:

- Staff dissatisfaction with the change
- Staff resistance to the change
- Loss of customers
- Reputational damage

Answer to Practice Question 4

- Costs of software packages
- Staff may need training
- Risk of corrupting client systems
- Risks of working with live data
- Relies on the quality of the data
- Experience needed to interpret the results of testing

CHAPTER 4

Fraud

Introduction

Professional accountants, especially when acting as auditors, have an important role in maintaining and improving public trust in organisations. Fraud is a global problem that undermines this trust, and this chapter will explore how fraud occurs and what can be done to prevent and detect it.

In this chapter we will learn about

- What fraud means
- How fraud affects organisations
- Internal controls and fraud
- Audit and fraud
- Money laundering

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
4.1	State the common types of fraud and their causes
4.2	Explain the financial and non-financial implications for an organisation if fraud occurs
4.3	Explain the role of internal controls in preventing and detecting fraud and error
5.9	Determine the action to take in relation to unethical behaviour or illegal acts, including money laundering, fraud and other illegal acts

Exam awareness

Fraud is a serious risk for all organisations, and accountants working at all levels need to be aware of it. In the exam you might be given a scenario where fraud risks are present and you are required to identify them, or you could be asked to design controls to prevent or detect fraud. You should be aware of the role and duties of management and auditors with regard to fraud.

1 Fraud and error

Introduction

For the professional accountant in the role of auditor, the primary concern is that the financial statements contain material misstatements arising from fraud. ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* is the relevant standard that deals with fraud and provides guidance to auditors.

1.1. Fraud

Definition:
FRAUD

Fraud is an intentional act by one or more individuals involving deception to obtain an unjust or illegal advantage.

The important thing to remember about fraud is that it is a **deliberate act** that involves **deception**. Fraud does not occur by mistake. It can be carried out by an individual or by a group of people acting together or colluding to commit the fraud. It can be committed internally by employees, management or those charged with governance, or externally by third parties.

Fraud is difficult to detect because those involved are secretive and careful to hide their activities, and their methods can be complex and sophisticated. It is important therefore that the auditor applies professional scepticism and conducts the audit with a questioning nature. This does not mean treating the audit client as if they were dishonest; trust and co-operation are important factors in the relationship between auditor and client. It does mean questioning and corroborating or confirming all information and audit evidence and being aware of the risk of fraud. The auditor is expected to have an enquiring rather than a suspicious mind; an audit is an examination, not an investigation.

Although an auditor is generally only concerned with material misstatements, ie those with a significant impact on the financial statements (see chapter 1) the presence of fraud, even if only on a small scale, will affect their judgement about the company concerned. Further audit work will need to be done to evaluate the extent of the fraud, to determine its potential effect on the financial statements, and to consider whether the auditor's evaluation of the client's system of internal control will need to be revised.

1.2. Error

Definition:
ERROR

Error is an unintentional misstatement or an omission of an amount or a disclosure.

Misstatements in the financial statements can arise from error, which, unlike fraud or irregularity, is unintentional. The auditor needs to be alert to the possibility of errors, especially if the system of internal control is weak. The auditor's concern is with material errors rather than with small discrepancies.

Now consider the following illustration.

Illustration 1.

Which of the following is a type of fraud, and which is an error?

- Missing out a row from a spreadsheet sum calculation
- Employee using work computer to run a private business
- Altering the total on an invoice
- Correcting a clerical error made by a junior member of staff
- Using an incorrect formula in a calculation

Answer to Illustration 1

- Missing out a row from a spreadsheet sum calculation: **Error (unless a deliberate attempt to manipulate information)**
- Employee using work equipment/stationery to run a private business: **Fraud**
- Altering the total on an invoice: **Fraud**
- A clerical error made by a junior member of staff: **Error**
- Using an incorrect formula in a calculation: **Error (unless deliberate)**

2 Types of fraud

Introduction

In the wider world there are many types of fraud, but we are concerned with fraud that leads to misstatements in the financial statements. The two types of fraud that are relevant to the auditor are: fraudulent financial reporting and misappropriation (theft or wrongful handling) of assets.

2.1. Fraudulent financial reporting

Fraudulent financial reporting uses deception to mislead or deceive the users of financial statements. The following are some of the methods used:

- Manipulating financial records or supporting documents through falsification or forgery
- Misrepresenting or omitting events, transactions or other significant information from the financial statements
- Misapplying accounting principles to amounts in the financial statements or their classification, presentation or disclosure

2.1.1. Management override

We have already noted that fraud is difficult to detect because of its hidden nature; this is especially the case when management is involved in fraudulent activity. Management have the means and ability to override controls that appear to be operating effectively. Management override techniques include:

- Fictitious journal entries
- Inappropriate assumptions and judgements for estimates
- Omission of events and transactions
- Omission of disclosures required for fair presentation
- Concealing facts relevant to amounts in the financial statements

- Complex transactions that misrepresent financial position or financial performance
- Altering records

2.2. Misappropriation of assets

Misappropriation of assets involves theft of assets owned by the entity or using those assets inappropriately. When employees are involved, the amounts can be small and therefore immaterial from an audit point of view. On the other hand, if management are involved, not only can the amounts be material, the fraudulent activity can be difficult to detect because of management override of otherwise effective controls.

The following are some examples of misappropriation of assets:

- Embezzlement (theft or misappropriation) of money
- Stealing physical assets such as inventory or intangible assets such as intellectual property or technical data
- Paying for goods or services not received by the entity, for example by setting up fictitious vendors or employees
- Using assets for personal gain

These activities are achieved by falsifying records to conceal missing assets or the lack of authorisation for the use of assets.

2.2.1. Materiality

The auditor is concerned with circumstances that can lead to material misstatements in the financial statements, and it is not the auditor's responsibility to detect fraud in an organisation. In fact, ISA 240 recognises that material fraud can remain undetected because of the inherent limitations of an audit. One of these limitations is the use of sampling for audit procedures; the auditor is almost never able to review all transactions. Another limitation is the ability of management to override established controls.

For some entities, such as public sector organisations, the auditor can have a broader responsibility with respect to fraud, because of the laws and regulations that apply to the public sector. It is understandable that tolerance of fraud, even on a small scale, is less acceptable when public funds are concerned, so the level of materiality is less significant.

2.3. Fraud in the public sector

The distinction between fraud and error in the public sector is arguably less important because the end result is the same; public services are deprived of the funding that they need in order to function properly.

The following are some examples of public sector fraud:

- Tax evasion
- Benefit/pension fraud
- Procurement fraud in government contracts
- Payroll and recruitment fraud
- Fictitious grant applications

A recent report published by the global organisation Corruption Watch identified a number of concerns in South Africa, including the mismanagement of public funds, falsifying recruitment documents, and ghost workers on public sector payrolls. The government has announced that the anti-fraud agency is to be re-established in order to address the problem of fraud and corruption.

Tackling fraud in the public sector can be difficult in a culture where the primary aim is to provide the service rather than deny access to it through carrying out burdensome checks on eligibility. Even so a focus on the prevention of fraud is a more efficient approach than detection and punishment, and technology, especially data analytics, can be used effectively in a co-ordinated prevention strategy.

3 Fraud risk factors

Introduction

The auditor should be aware of various fraud risk factors and certain events or conditions that can lead to fraud being committed:

- Incentive or pressure
- Opportunity
- Ability to rationalise fraudulent actions

3.1. Risk factors: Fraudulent financial reporting

Appendix 1 of ISA 240 provides an extensive list of fraud risk factors, for example:

- Incentives/pressures, which could be relieved by committing fraud:
  - Competition in the market, so market share reduced
  - Rapid technological changes that the organisation cannot keep up with

- Decline in customer demand
- Operating losses
- Negative cash flows
- New accounting, statutory or regulatory requirements that might be difficult to fulfil
- Management bonuses that depend on financial performance
- Adverse effect of poor financial results, e.g. laying off staff, closing a branch

- Opportunities for committing fraud:
  - Significant related party transactions, i.e. transactions with another person or organisation that has a close association with the audited entity, either through a long-standing business relationship or through a common interest
  - Estimates based on subjective judgements; amounts may be stated too highly
  - Unusual or complex transactions which can be used to hide a fraud
  - Use of tax havens
  - Complex or unstable organisational structure
  - Deficiencies in internal controls, so less scope for preventing or detecting fraud
  - High turnover of staff, so there is less chance of someone else noticing the fraud
  - Inadequate accounting systems
- Attitudes/rationalisations that might encourage fraud:
  - Lack of ethical standards within the organisation
  - Lack of enforcement of ethical standards
  - Violations of laws or regulations
  - Low morale among staff
  - Strained relationships between management and auditors
  - Domineering management behaviour

3.2. Risk factors: Misappropriation of assets

Appendix 1 of ISA 240 provides an extensive list of fraud risk factors, for example:

- Incentives/pressures:
  - Personal financial problems, which may tempt employees to steal
  - Employees with grievances, such as threat of redundancy
- Opportunities:
  - Handling large amounts of cash

- Inventory comprises items that are portable and have high value, such as laptop computers or jewellery
- Items that are not marked with ownership
- Inadequate internal controls, for example:
  - Lack of segregation of duties
  - Inadequate oversight of expenses
  - Inadequate supervision especially in remote locations
  - Poor screening in recruitment processes, eg not taking up character references
  - Poor record keeping with regard to assets
  - Inadequate authorisation and approval over purchasing transactions
  - Poor physical safeguards
  - Lack of reconciliation controls, eg bank reconciliations
- Poor understanding by management of technology, automated records and systems logs

- Attitudes/rationalisations:
  - Disregard for the need for monitoring and reduction of risks of misappropriation
  - Overriding existing internal controls
  - Failing to take action where there are deficiencies in internal controls
  - Employees displaying dissatisfaction
  - Unexplained changes in behaviour or lifestyle of an employee, eg an expensive new car but their salary is low
  - Tolerance of petty theft as routine

4 Implications of fraud

Introduction

The consequences of fraud can be serious for the entity, those carrying it out and the auditor. The implications depend on the nature of the fraud, how it occurred and the effect on the financial statements.

4.1. Implications for the entity

An organisation where fraud has been discovered will suffer reputational damage and will lose the trust of customers, suppliers and investors. Loss of cash or assets on a large scale could have an adverse effect on the entity's ability to continue operations.

In the public sector the implications of fraud are: money intended for public services is lost, and trust in government institutions is undermined.

4.2. Implications for the person committing the fraud

Those responsible for committing fraud will be subject to disciplinary procedures within the organisation. Depending on the severity it could be classified as gross misconduct leading to dismissal. If the case is referred to law enforcement agencies there will also be criminal penalties.

Different countries have different laws; fraud could be prosecuted under a general theft act or there could be specific legislation that relates to fraud offences. You should familiarise yourself with the situation in your country.

4.3. Implications for the auditor

The auditor is concerned with the effect of fraud on the financial statements. There is sometimes a perception that auditors are responsible for detecting fraud, but this is not the case, as was mentioned in section 2.1.1 and we shall see later in section 6 of this chapter. Auditors are, however, expected to draw attention to any deficiencies in internal control; if uncorrected these deficiencies could provide opportunities for fraud in the future.

If the financial statements are materially misstated because of fraud, the auditor needs to consider how this affects the audit. There might be a legal requirement to report the fraud outside the organisation, and in exceptional circumstances the auditor should consider whether it is appropriate to withdraw from the audit.

Self-study 1.

Have there been any large-scale corporate frauds in your country? If so, how were they discovered and what were the consequences? What measures could have been put in place to prevent the fraud from occurring in the first place? Are you aware of any international examples of fraud or other corporate misconduct?

Some suggestions are provided at the end of this chapter.

5 Internal controls and fraud

Introduction

A sound system of internal controls, properly implemented, is essential to reduce the risk of fraud in an organisation.

5.1. Internal controls and fraud prevention

A good system of internal controls will have controls in place to prevent, detect and correct misstatements. The following are examples of controls that address the risk of fraud:

- Documented policies and procedures relating to conduct and fraud prevention
- Communicating these policies to employees, customers and suppliers
- Strong counter-fraud message from senior management
- Segregation of duties
- Regular reconciliations
- Physical security of assets
- IT access and usage logs
- Authorisation and approval of transactions
- Inventory counts
- Supervision
- Vetting of new employees
- Recruitment, appointment and promotion policies
- Robust data back-up

Practice question 1

What type of internal control would be the most effective in preventing the theft of inventory items?

You will find the answer at the end of the chapter.

6 Responsibilities of auditors and management

Introduction

ISA 240 clarifies the responsibilities of management, those charged with governance and the auditor.

Definition:
MANAGEMENT

Management: the persons with executive responsibility for a company's day to day operations.

Definition:
THOSE CHARGED WITH GOVERNANCE

Those charged with governance: the persons responsible for overseeing the strategic direction and accountability of the company, including the financial reporting process.

6.1. Responsibilities of management

Management and those charged with governance (typically the board of directors) have the primary responsibility for the prevention and detection of fraud in an organisation. They should set the tone from the top by making it clear that fraud will not be tolerated and will be punished when discovered. Promoting and demonstrating a culture of honesty, integrity and ethical behaviour is indicative of good governance. A strong emphasis on fraud prevention and deterrence reduces the opportunities for fraud.

Management are responsible for ensuring that an adequate system of internal control is in place, and for identifying the potential for override of controls. Management are also responsible for the prevention, detection and internal investigation of fraud, and for involving law enforcement agencies where appropriate.

In some organisations, especially small or owner-managed companies, management and those charged with governance are the same people so there is no distinction between the two.

6.2. Responsibilities of the auditor

The auditor is responsible for planning and conducting the audit in order to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud. The auditor does this by assessing the risk of fraud and designing appropriate audit procedures in order to obtain sufficient appropriate audit evidence. The inherent limitations of an audit mean that some misstatements may not be detected even when the audit is properly conducted in accordance with ISAs.

Practice question 2

Which attribute of the professional accountant is relevant when dealing with suspicions of fraud?

You will find the answer at the end of the chapter.

7 Money laundering

Introduction

Money laundering is an increasing problem world-wide. Money laundering deprives counties of much-needed revenue and contributes to the spread of criminal activities.

7.1. The consequences of money laundering

Definition:
MONEY LAUNDERING

Money laundering: the process of channelling the proceeds of criminal activity through legitimate businesses in order to conceal the illegal origins of funds.

Once money obtained through criminal means has been 'cleaned' it can be used for legitimate purposes but more often it is used to fund further illegal activities including:

- Terrorism
- Organised crime
- Drugs and arms smuggling
- Human trafficking

You will see from the above examples why governments across the world are keen to crack down on money laundering, and in many countries it is a criminal offence in itself.

7.2. Examples of money laundering as fraud

The term money laundering covers not only disguising illicit funds, but it can also refer to gains made from non-compliance with laws, regulations, and honest business practice. Examples include:

- Tax evasion
- Dishonest behaviour such as bribery
- Deliberately keeping overpayments for customers
- Fly-tipping, i.e. dumping rubbish or unwanted items in the countryside rather than in licenced areas
- Illegal disposal of toxic waste
- Exploiting child labour

7.3. Responsibilities of the professional accountant

The professional accountant must employ professional scepticism to be aware of indications that money laundering is taking place. These include:

- Unusual transactions
- Transactions without proper supporting documentation
- Analytical procedures indicate that credit balances on the receivables ledger are unusually large (customers who are overpaying by large amounts could be suspicious)
- Expected costs missing from the profit or loss account
- Low payroll costs for the number of employees on the payroll
- Large transactions in cash
- Accepting cash without a sound business reason for doing so
- Over-complicated group structures and unnecessary internal transfers of funds

In countries where money laundering is recognised as a criminal offence in its own right, the laws and regulations in place in that country will determine how the professional accountant should act when they become suspicious of money laundering activities. There will usually be a duty to report suspicions to a designated officer within the firm, for example the Money Laundering Nominated Officer (MLNO) and to the appropriate law enforcement authority.

Care must be taken to avoid tipping off a suspect, and to ensure that contacting outside agencies will not be deemed a breach of client confidentiality.

Chapter summary

You should now be able to:

- Identify types of fraud
- Explain the implications of fraud
- Identify the responsibilities for fraud prevention and detection
- Recognise possible indicators of money laundering

Please check your understanding by attempting the self-test questions below.

Self-test questions

1. Fraud can happen accidentally through genuine mistakes. Is this statement TRUE or FALSE?
2. Which TWO of the following are examples of fraudulent financial reporting?

   A. Forgery of documents

   B. Embezzlement

   C. Stealing inventory

   D. Omission of significant transactions
3. Which of the following is a fraud risk factor that provides an incentive for the misappropriation of assets?

   A. Competition in the market

   B. Significant related party transactions

   C. Management bonuses that depend on financial performance

   D. Employees with grievances such as threat of redundancy
4. Even a robust system of internal controls cannot guarantee that fraud will not occur. Why is this the case?
5. Who is responsible for preventing and detecting fraud in an organisation?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 12.1 to 12.8
- Questions 14 and 15

Answers to practice questions

Answer to Practice Question 1

Physical controls such as locked doors and restricted keypad access to stores. Supervision of staff is also a relevant control.

Answer to Practice Question 2

Professional scepticism – this means having a questioning mind and being alert to conditions that might indicate a risk of fraud. It also means acting on evidence and not jumping to conclusions without a thorough investigation.

Suggested answers to self-study questions

Answer to Self-study 1

The collapse of the Enron Corporation in the United States is one of the most infamous examples of corporate fraud in the 21st century. Enron executives used dubious accounting practices and complex corporate structures to hide massive losses. Senior figures received lengthy prison sentences, and the scandal also led to the collapse of the accountancy firm Arthur Andersen, who were Enron's auditors.

In 2020 German payment processing company Wirecard acknowledged a €1.9bn accounting fraud when balances of that value were found to be 'missing'. The auditors, EY, had failed to verify the existence of cash reserves or to identify fraudulent bank statements.

One of the biggest scandals in Africa in recent years involved South African company Steinhoff, who inflated profits and assets by R250 billion. The scandal also involved manipulating the accounts, forging documents and secretive dealings between senior officials and supposedly independent third parties.

CHAPTER 5

Ethics for the professional accountant

Introduction

Professional accountants provide important and valuable services to organisations and to the public. In order to do this successfully they must demonstrate professional behaviour at all times. Ethical codes provide the foundation and guidance on ensuring high standards in professional life.

In this chapter we will learn about:

- Codes of ethics and their importance
- The fundamental principles enshrined in ethical codes
- Independence and its relationship with the principle of objectivity
- Threats to the principles and to independence, and safeguards than can be put in place to mitigate those threats
- Confidentiality in professional and business relationships
- The consequences of failing to act in a legal and ethical manner

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
5.1	State the role of regulatory bodies and ethical codes and their importance to the accounting profession
5.2	Recognise the difference between a rules-based and principles-based approach
5.3	Explain the fundamental principles according to the IESBA Code of Ethics
5.4	Identify the threats (self-interest, self-review, advocacy, familiarity, management, intimidation) to the fundamental principles
5.5	Identify and evaluate safeguards to eliminate or reduce ethical threats to the fundamental principles
5.6	Explain the importance of independence for professional accountants and its relationship with objectivity
5.7	Explain the importance of confidentiality and the possible exceptions when an accountant may breach a client's confidentiality
5.8	Understand the potential consequences of failing to observe ethical behaviour and comply with the Code of Ethics
5.9	Identify the action to take in relation to unethical behaviour or illegal acts
5.10	Explain the meaning of 'whistle-blowing' or 'speaking out' procedures

Exam awareness

Ethical principles are a fundamental part of this module, and the examination will inevitably contain a question on ethics. The topic can be examined in the MCQ section of the paper and also in a written question where you could be presented with a scenario that contains an ethical dilemma or problem. It is important that you understand the fundamental principles and can apply your knowledge to real-world situations. Ethical principles apply to all aspects of a professional accountant's work, whether they work in business or in an accountancy firm, in the private or public sector.

1 Ethical Codes and Fundamental Principles

Introduction

In this first section we will be looking at the international Code of Ethics developed by IESBA and the fundamental principles set out in the Code.

1.1. Regulatory bodies and ethical codes

The accountancy profession is regulated by law, the rules of the institutes to which accountants belong, and by international standards relating to financial reporting and auditing. The International Ethics Standards Board for Accountants (IESBA) is part of the International Federation of Accountants (IFAC) and they have developed a Code of Ethics. This Code has been adopted by many accountancy bodies across the world, either in its entirety or adapted to reflect local needs.

It is essential that accountants have a good reputation with the public, who rely on the information that accountants produce. Auditors in particular must be independent, and having an ethical code helps to demonstrate to those outside the profession that accountants conduct themselves according to accepted principles.

Definition: **ETHICS**

Ethics: The system of moral principles that determine how an individual behaves. Ethical behaviour involves doing what is right and avoiding what is wrong.

The Code is principles-based rather than rules-based. This means that it provides broad guidelines that can be applied to individual circumstances. A principles-based Code is more flexible than a strict rules-based approach, and is more adaptable to changing circumstances.

A rules-based approach, on the other hand, can encourage a culture of 'ticking the right boxes' and finding loopholes rather than embracing the spirit of the guidance in all situations.

The first part of the IESBA Code sets out the fundamental ethical principles.

1.2. IESBA code: fundamental principles

There are five fundamental principles contained in the IESBA Code. We will now look at each of these principles in turn.

1.2.1. Integrity

Definition: **INTEGRITY**

Integrity: Professional and business relationships should be conducted in a straightforward and honest manner.

This means being fair, truthful and honest at all times, and avoiding being associated with information that:

- Is false or misleading
- Is provided recklessly
- Omits or obscures information that is required for proper understanding

A professional accountant will take every care to ensure that information is valid and truthful, and will act with honesty at all costs.

1.2.2. Objectivity

Definition: **OBJECTIVITY**

Objectivity: Professional or business judgements should be made without showing bias and should not be influenced by others.

A professional accountant should not take part in any professional activity if there are circumstances or relationships that unduly influence professional judgement.

Activities that involve a conflict of interest, bias, personal self-interest or pressure from others should be avoided. Objectivity is closely related to independence, which we will discuss in more detail later in this chapter.

1.2.3. Professional competence and due care

Definition: **PROFESSIONAL COMPETENCE AND DUE CARE**

Professional competence and due care: Professional accountants should have the necessary skills and knowledge to carry out their role and should keep up to date with developments in the profession and the wider business world.

Accountants acquire knowledge and technical skills through study, training, experience and continuing professional development. A competent professional should not undertake tasks that they are not qualified to do.

A professional accountant should act diligently in accordance with technical and professional standards, and should apply professional judgement to all tasks undertaken on behalf of clients and employers.

1.2.4.

Definition:
CONFIDENTIALITY

Confidentiality

Confidentiality: Confidential information should not be disclosed to third parties unless there is a legal or professional duty to do so.

Accountants have access to confidential information about clients, their business activities, and their personnel. Making this information available to third parties without permission would be a breach of confidentiality and could lead to legal sanctions for the firm or the individual. It is also in the public interest to have confidence that the confidential information obtained by the professional accountant will not be disclosed to third parties.

- Professional accountants should take care that confidential information is not disclosed in a social environment, including social media, or to family or business associates. This applies even after the relationship with the client has ended.
- Confidential client information should not be used for personal gain or for the benefit of third parties.

In some circumstances, however, there may be a duty to disclose confidential information, for example to law enforcement agencies investigating suspected criminal activity. There may be a duty to disclose confidential information where this is in the public interest and local legislation allows this. We shall look at this in more detail in Section 4.

1.2.5.

Definition:
PROFESSIONAL BEHAVIOUR

Professional behaviour

Professional behaviour: Professional accountants should ensure that their actions do not damage the reputation of the profession.

This means ensuring compliance with any laws, regulations or standards relevant to the profession and avoiding any behaviour that goes against the fundamental principles.

A professional accountant should not be involved in any business or activity that could have a negative impact on the integrity, objectivity or reputation of the accountancy profession.

Self-study 1.

Have you encountered an ethical dilemma in your professional career? What advice was available to you? Did you refer to a code of professional ethics?

In your personal life, has anyone ever asked you to do something that you were uncomfortable with, in return for a reward perhaps? You might have been asked to tell a lie, for example, to cover for someone else's wrongdoing. As an individual you would apply your own moral code and your own beliefs regarding right and wrong.

Practice question 1

Which of the following is NOT an ethical principle contained in the IESBA Code?

- Integrity
- Professional competence and due care
- Objectivity
- Professional qualifications

You will find the answer at the end of the chapter.

2 Independence

Introduction

Independence is closely associated with the ethical principle of objectivity and is of particular importance for professional accountants who provide assurance services such as audit. In fact the auditor's report produced in accordance with ISA 700 specifically states that the opinion on the financial statements is independent.

2.1. The importance of independence

Auditors in particular need to demonstrate that they are independent of management and that they provide an objective and impartial view. This is important for the shareholders of the company who receive auditor's reports, and also for the public in general. Auditors and other professional accountants must be seen to be ethical in their behaviour if the public is to have trust in the work they do.

2.2. Demonstrating independence

Independence is a state of mind that allows for no conflict of interest to compromise integrity and professional judgement. It means acting objectively and exercising professional scepticism. This is known as independence in fact.

Independence is also a matter of appearance. This means acting in such a way that raises no doubts in the mind of a third party. This is known as independence in appearance.

3 Threats and safeguards

Introduction

Sometimes situations in an accountant's professional life can pose a threat to ethical behaviour, especially to objectivity and independence. Some situations will represent more than one type of threat. In this section we will look at those threats and at the safeguards that can be put in place to deal with them. First of all, we shall consider how to identify when a threat is present, by applying the 'reasonable and informed third party' test.

3.1. Reasonable and informed third party

When considering threats, the IESBA Code applies the test of a reasonable and informed third party. This party does not need to be an accountant, but should have the knowledge and experience to be able to consider the facts and circumstances, and to conclude whether or not a threat to independence and/or objectivity exists.

3.2. Self-interest threat

This is a threat to objectivity that arises when there is a financial or other interest in a client, either on the part of the firm, an individual within that firm or a close family member. Such interest can arise from, for example:

- Close business relationships between the firm and the client, for example the audit team have worked with that client for many years
- Financial interest such as owning shares in the client, or obtaining a loan from a financial services client at favourable rates that are lower than normal commercial or market rates
- Accepting significant gifts or hospitality from the client
- Overdue fees which could be regarded as a loan from the client
- One client representing a large proportion of the firm's fees, so the firm relies in that client and would be unwilling to lose it
- Fees that are contingent on a desired result, such as an assurance report with no negative points
- Quoting an unrealistically low fee in order to obtain a new assignment and to beat other competitors tendering for the work (known as 'low-balling')

Safeguards can include:

- Changing the audit team
- Disposing of any financial interest such as shares

- Policies on accepting gifts and hospitality – generally any items that would not be deemed trivial and inconsequential by a reasonably informed third party should not be accepted
- Collecting overdue fees before issuing the audit report, so that the client cannot threaten to withhold them
- Monitoring fee income from clients to make sure that no one client contributes too much
- Refusing contingency fee arrangements
- Avoiding 'low-balling'

For audit clients that are listed on a recognised stock exchange, the IESBA Code states that, if the proportion of fee income exceeds 15% of total fee income for two consecutive years, this should be disclosed to those charged with governance.

Illustration 1.

Kabeta & Co have carried out the external audit of Amara Co for many years and provide other services to the company. The fees from Amara Co make up 60% of Kabeta & Co's revenue. This represents a threat because the firm might be reluctant to question or criticise the company and risk losing their biggest client.

3.3. Self-review threat

This threat to independence occurs when a firm that provides assurance services to a client also provides the same client with other services. Examples of these other services include:

- Internal audit
- Completing tax returns
- Preparing financial statements
- Preparing accounting records
- Valuation services for the valuation of non-current assets
- Designing IT internal controls

When the firm is reviewing the systems and records of a client during an audit, they could be looking at work done by other employees of the firm, for example colleagues in the tax department. This would affect their independence as the audit team could be reluctant to find fault with the work of colleagues.

Safeguards include:

- Ensuring that internal audit services do not contain a management element
- Using separate teams in the firm to carry out audit and non-audit work

The IESBA Code allows firms to provide most non-audit services to audit clients but there are special rules for listed clients:

- Valuation services may not be provided for items that are material to the financial statements
- Internal audit services must not involve internal controls over financial reporting
- IT services must not involve the design or implementation of systems that feed into the financial reporting process

A self-review threat can also arise when audit personnel have previously been directors or employees of an audit client. If they held positions that had significant influence over the financial reporting process, they should not be part of the audit team until two years have elapsed since they were employed with the audit client.

The IESBA Code states that a partner or employee of an audit firm may not serve as a director or officer of an audit client as this would create a self-review (and self-interest) threat. Audit firms are, however, permitted to loan staff to an audit client subject to the following considerations:

- The loan of staff is for a short time only
- Audit team staff on loan to the audit client are not involved in providing non-audit services that are prohibited by the Code (see above)
- Audit team staff on loan to the audit client do not have management responsibilities
- The audit client is responsible for direction and supervision of the staff on loan

Illustration 2.

During the financial year ended 31.07.X2 da Silva Co experienced problems recruiting staff for their accounts department. Their auditors, Raj & Co, provided temporary staff from their audit team to fill the vacancies. When Raj & Co carry out the audit of the financial statements, some of the accounting records will have been produced by their own staff, and this represents a self-review threat.

3.4. Advocacy threat

An advocacy threat occurs when a firm acts on behalf of a client, for example in a court of law.

Safeguards against advocacy threat can include:

- Using separate departments within the firm
- Disclosing potential threats to the audit committee (see Chapter 6)

Illustration 3.

An audit client asks their auditors to negotiate with the bank for an increase in their overdraft facility. This would mean acting on behalf of the client and representing them, and is therefore an advocacy threat.

3.5. Familiarity threat

This threat to independence and objectivity arises when a firm has had a long relationship with an audit client. It can also occur where there are family or personal relationships between the audit client and the engagement firm.

Safeguards can include:

- Rotating senior staff on the audit team
- Removing audit staff who have close family or personal relationships with the client
- Putting policies in place for declaring relationships with audit clients
- Requiring staff to declare any conflicts of interest

For audit clients that are listed on a recognised stock exchange, the IESBA Code does not permit an audit engagement partner to act in that role for more than seven consecutive years.

Illustration 4.

The audit engagement partner was recently employed as finance director by the audit client. This makes it harder for the firm to review the work of the finance function in an objective manner.

3.6. Intimidation threat

Intimidation occurs when the client puts pressure on the firm or threatens legal action over work completed.

Safeguards can include:

- Making disclosure to the audit committee
- Removing members of staff affected from the audit team
- Obtaining external professional assistance, such as legal advice

Illustration 5.

The audit client is threatening to sue the firm unless it amends a critical auditor's report. This puts pressure on the firm and is a threat to objectivity.

Practice question 2

An audit client has said to the audit engagement partner that any criticisms in the auditor's report would not be acceptable, and the audit fee would not be paid if that were the case. Explain why this is a threat and state what type of threat is described here.

You will find the answer at the end of the chapter.

3.7. Safeguards

There are specific safeguards that can be put in place in response to specific threats, as we have seen above. The IESBA Code also identifies two general categories of overall safeguards that can be put in place:

3.7.1. Safeguards created by the profession, legislation or regulation

- Requirements for entry into the profession such as education level, training and experience
- Continuing professional development
- Corporate governance
- Professional standards
- Monitoring and disciplinary procedures
- External reviews

3.7.2. Safeguards in the work environment

- Review of work done by another professional accountant
- Consultation with a third party
- Rotation of senior staff
- Disclosure of services and fees to those charged with governance
- Declarations of independence

Practice question 3

Explain why it is unacceptable for the audit engagement partner to make executive and management decisions on behalf of an audit client.

You will find the answer at the end of the chapter.

4 Confidentiality

Introduction

In this section we will look more closely at this ethical principle and consider some practical ways to ensure compliance.

4.1. The importance of confidentiality

When a client gives accountants access to confidential information, they should feel assured that the information will remain confidential. To reveal information that the client would not wish to be made public would be a betrayal of trust and would also bring the profession into disrepute.

4.2. Safeguarding confidentiality

The changing nature of working and doing business mean that accountants and auditors will not always be working on client documents on the premises. Deliberately revealing confidential information would be a serious breach of trust, but disclosure can also be accidental, and firms should put in place procedures to prevent this. Such procedures could include a policy that states:

- Client information should not be discussed outside the firm
- Discussions with colleagues should not take place in public where they could be overheard
- Documents should not normally be removed from client premises or from the firm's offices
- Audit files and other physical documents should not be left unattended
- Electronic devices and remote access, including passwords, should have appropriate security

4.3. Disclosure of confidential information

There are some circumstances when disclosure of confidential client information is permitted.

- The client has given permission for the information to be disclosed
- The jurisdiction recognises a duty to disclose certain information as it is in the public interest to do so
- There exists a legal or professional duty to disclose the information
- The relevant law requires disclosure, for example in the case of:
  - Fraud
  - Money laundering
  - Tax evasion
  - Terrorism

Practice question 4

The principle of confidentiality always applies even where there is suspicion of money laundering. Is this statement TRUE or FALSE? Explain your answer.

You will find the answer at the end of the chapter.

4.4. Conflicts of interest

Audit firms will sometimes find that there is a conflict of interest between audit clients, especially if the clients are in competition with one another or if there is a dispute between them. In such circumstances the audit firm should put in place safeguards to manage the conflict. One example of a safeguard is the setting up of information barriers that include the following measures:

- Using separate audit teams for the conflicting clients
- Ensuring that the work of the teams does not overlap
- Setting up robust procedures for safeguarding client information and keeping documents and electronic files separate

The firm should also disclose any conflict identified to each client and obtain their consent to continue with the audit assignment. Unless the conflict can be managed, the firm should not serve as auditor to both clients.

5 Unethical behaviour and consequences

Introduction

In this final section we shall consider the consequences to firms and individuals when there is a breach of ethical principles.

5.1. Implications for the entity

An organisation where unethical behaviour has been discovered will suffer reputational damage and will lose the trust of customers, suppliers and investors.

5.2. Implications for the professional accountancy firm

There could be sanctions from regulatory bodies against individuals or the firm as a whole. These can include fines or even expulsion from the regulatory body.

In the UK, for example, the collapse of Carillion in 2018 with debts of £7bn was the biggest corporate failure in decades. Investigations into what went wrong are continuing, and the auditors, KPMG, are facing a fine of £1.3bn for negligence.

5.3. Implications for the individual

Depending on the severity it could be classified as gross misconduct leading to dismissal. If the individual is a student or qualified member of a professional body, there could be disciplinary action and possible disqualification from the institute. If the unethical behaviour amounts to a criminal act this will be investigated by the appropriate law enforcement authorities.

In the Carillion case mentioned above, some of the individual auditors concerned have been fines and received reprimands from their professional body.

5.4. Whistleblowing and 'speaking out'

Whistleblowing provides an employee with the means to speak out in the public interest when they become aware of wrongdoing in their organisation, whether perpetrated by colleagues, their employer, a client of the organisation or a third party. Whistleblowing is an act of disclosure or organisational wrong-doing to external parties who can take appropriate action. The whistleblower does not have to be directly affected but they can be. Examples of wrongdoing include:

- Illegal acts and criminal offences such as fraud
- Financial malpractice or false accounting
- Breaches of health and safety regulations
- Breaches of environmental regulations resulting in risk or actual damage to the environment
- Miscarriages of justice
- Covering up for the malpractice or wrongdoing of others

Employers should have a clear policy on whistleblowing, communicated to all employees. In some countries whistle-blowers are protected by law, for example in the UK the Public Interest Disclosure Act has measures to ensure that whistle-blowers are not treated unfairly or have their jobs put at risk. Whistleblowers may also have the right to remain anonymous and to have their identity protected by law.

Practice question 5

What measures could you personally take to ensure that information belonging to an audit client remains confidential?

You will find the answer at the end of the chapter.

Chapter summary

You should now be able to:

- Identify ethical principles
- Recognise threats and safeguards
- Explain the importance of independence and confidentiality
- Explain the consequences of unethical behaviour

Please check your understanding by attempting the self-test questions below.

Self-test questions

1. The audit manager responsible for the audit of Khader Co owns shares in the company. This is a threat to which of the ethical principles?
2. Which ethical principle requires accountants to keep up to date with developments in the accountancy profession?
3. The IESBA Code of Ethics contains detailed rules for accountants to follow. Is this statement TRUE or FALSE?
4. An audit client has told the engagement partner that their appointment will be terminated if they issue a qualified auditor's report. Which type of threat is this?
5. Which principle prevents accountants from revealing client information to third parties without consent?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 15.1 to 15.6
- Questions 16 and 17

Answers to practice questions

Answer to Practice Question 1

Professional qualifications

Answer to Practice Question 2

The client is threatening the auditor with non-payment of fees. This is an intimidation threat.

Answer to Practice Question 3

This would be a threat to independence and also a self-review threat as any management decisions would later be subject to audit.

Answer to Practice Question 4

FALSE. There may be laws in place that require the auditor to report criminal activity, regardless of the principle of confidentiality.

Answer to Practice Question 5

Personal measures could include:

- Not discussing client information in public or on social media
- Keeping audit files secure and not leaving them unattended when out of the office or when not on the client's premises
- Keeping passwords secure

CHAPTER 6

Corporate governance and corporate social responsibility (CSR)

Introduction

Large corporations, some of which are global in their reach, and national public institutions have a great deal of influence on the economy, society and the environment in which they operate. It is therefore important that they are run and managed properly for the benefit of stakeholders and the wider public. This chapter will consider the principles of good corporate governance, and how these are demonstrated and communicated. We shall also look at the increasing demand for ethical investments and business practices, and how organisations are responding to this demand.

On completion of this chapter, students should be able to explain the importance of corporate social responsibility (CSR) and sustainability for organisations and explain the importance of corporate governance in organisations.

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
6.1	Describe how organisations embed corporate social responsibility (CSR)
6.2	Describe the characteristics and benefits of sustainable business practices for organisations, stakeholders, society and the environment
7.1	State the reasons why corporate governance of an organisation in either the public or private sector is needed and explain the role that governance plays in the management of an organisation
7.2	Explain the roles and responsibilities of those charged with corporate governance and those charged with management
7.3	State the policies and procedures that an organisation should apply in order to promote effective governance

Exam awareness

Corporate governance and ethical business practices are very topical areas of the syllabus. Exam questions will be primarily knowledge based but corporate governance issues could also be part of a long form scenario question in Part B of the examination.

1 Introduction to corporate governance

Introduction

Good corporate governance is important in both the private and public sectors. Failure to curb corporate greed and wrongdoing has led to the collapse of companies all over the world and also to the demise of major accountancy and audit firms. Poor corporate governance in the public sector means that government resources, funded by taxpayers or donors, are not well-utilised or are wasted.

1.1.

Definition of corporate governance

Definition: **CORPORATE GOVERNANCE**

Corporate governance: the system by which companies are directed and controlled.

When considering the private sector, the definition needs us to think about the role of the directors of a company who make executive decisions on behalf of the owners or shareholders. This stewardship role demands integrity, accountability and transparency to ensure that executive power is not abused.

Responsibility for good corporate governance, however, extends beyond the immediate responsibility to shareholders. Other stakeholders are affected by the actions of corporate entities, such as lenders, customers, suppliers, employees, and the general public.

Corporate governance arrangements enable organisations to meet their objectives in the legal, regulatory, market and social environment in which they operate, and generate trust in the organisation.

In the next section we shall be looking at some examples of frameworks for corporate governance, one of which has been developed by the Organisation for Economic Cooperation and Development (OECD). This is how the OECD describes corporate governance:

Definition: **CORPORATE GOVERNANCE**

> ***Corporate governance*** *involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.*
>
> *— G20/OECD Principles of Corporate Governance, 2015*

You will notice from this quotation that the references are to a company. In a company the directors have a responsibility to act within the powers embedded in the company's constitution and to promote the success of the company in good faith. In doing so they must exercise independent judgement, act with reasonable care, skill and diligence, and avoid conflicts of interest.

The same principles of corporate governance are equally relevant to public sector organisations. Governance in the public sector is discussed in more detail in Chapter 7.

1.2.

The development of corporate governance in Africa

Traditionally corporate governance frameworks in Africa have not been well developed but there is increasing awareness of the importance of good governance arrangements in promoting the growth and development of economies and

societies. Countries that are in a more advanced state of development have, unsurprisingly, more advanced frameworks of corporate governance in place.

Progress in the development of corporate governance is different in each African country, partly because of the current political and economic environment, and partly because of historical influences that still prevail. Countries that have adopted and adapted an existing legal system have more advanced arrangements in place, for example Ghana, Kenya and Zambia. Less developed are those where state control of the economy has prevailed post independence, for example Mozambique, Uganda, Tanzania and Tunisia.

Self-study 1.

What are the arrangements for corporate governance in your country?

- Are corporate governance codes/principles mandatory or voluntary?
- Are there different arrangements for different sectors or types of entity, for example private/public sector, listed/non-listed companies?
- How is compliance measured and reported?
- Is there a reporting role for auditors or other assurance providers?

1.3. Corporate governance in the public sector

We shall be looking at the public sector in more detail in Chapter 7. There are several key difference between the private and public sectors when it comes to corporate governance, notably relating to governing bodies' structures and reporting arrangements, the range of stakeholders and funding. However, both private and public sector apply common corporate governance principles and practices.

1.3.1. Governing bodies' structures and reporting arrangements

Ministries and Departments are governed by the Executive Authority (the Minister) and Accounting Officers (Head of the Department). Public entities have a Board of Directors appointed based on prescribed guidance of the shareholders, the responsible Ministry or Department. The Ministries, Department and Public entities reports are submitted to Parliament through the responsible Minister.

In municipalities, the governing body is the Municipal Council, Governing body members are the Councillors who are democratically elected by registered voters within a municipality, and the Chair of the Governing Body in the Speaker of the Council.

1.3.2. Range of stakeholders

Public sector organisations have a much wider range of stakeholders. The public sector provides goods and services that are not normally associated with private companies, such as defence and policing. In many countries the public sector represents a large part of the economy, therefore the impact on society is significant.

1.3.3. Funding

Funding for the public sector is through taxation or other government funding rather than through shareholder investment. Taxpayers and the users of public services can be the same people, for example taxpayers send their children to school or use health care where these are provided by the state. Accountability for the legitimate and prudent use of funds, demonstrating successful outcomes, and acting fairly are all therefore important aspects of public sector governance arrangements.

2 Corporate governance codes

Introduction

There is no one single code or set of principles for corporate governance that has been adopted world-wide. Different countries have different arrangements that can be mandatory or voluntary. There can also be different arrangements for different types of company, for example between companies that are listed on a stock exchange and those that are in private hands. In this section we shall look at some examples that are available for countries or sectors to adopt.

2.1. OECD

The OECD first published a set of principles in 1999 and the latest version of the *Principles of Corporate Governance* was issued in 2015. The principles provide a benchmark for developing and enhancing corporate governance arrangements internationally.

The principles are arranged over six chapters:

Table 1. OECD Principles of Corporate Governance

Chapter	Principle
I. Ensuring the basis for an effective corporate governance framework	The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.
II. The rights and equitable treatment of shareholders and key ownership functions	The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
III. Institutional investors, stock markets, and other intermediaries	The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.
IV. The role of stakeholders in corporate governance	The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.
V. Disclosure and transparency	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
VI. The responsibilities of the board	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

You will notice from this table that the main emphasis is on shareholders and their rights, stock markets, and accountability to the company. Stakeholders and wider social considerations are mentioned in chapter IV of the OECD Principles, which lists investors, employees, creditors, customers, suppliers and other stakeholders whose interests should also be recognised in the corporate governance framework. The primary stakeholders of corporations are usually the owners who invested the initial capital and the creditors who provide the funds that sustain ongoing operations.

2.2. King Reports (South Africa)

The King Reports on corporate governance in South Africa have been published and updated since the 1990s, The updates are mainly due to global developments and high-profile corporate failures around the world. Enron and WorldCom in the United States are two famous examples that are still mentioned today when discussing corporate failure and the role of auditors and the audit assurance process.

The principles of corporate governance deriving from the King Reports emphasise the need to consider all legitimate stakeholders, not just shareholders, and recognise the interaction of businesses with society and the environment.

The latest report, King IV (2016)[1] provides principles and practices that organisations should implement to achieve the following outcomes:

- Ethical culture
- Good performance
- Effective control
- Legitimacy

There is greater emphasis in the King principles on good corporate citizenship and on recognising that corporations are an integral part of society. They are therefore accountable to the stakeholders in that society both now and in the future. They are treated as corporate citizens in their capacity as artificial persons.

Some aspects of the King Reports are enshrined in the Companies Act in South Africa, where companies are required to 'apply and explain' compliance with the principles. The King Reports are applicable to all types of organisation, and King IV includes additional specific supplements relating to, for example, municipalities, stated-owned enterprises (SOEs), small and medium sized enterprises (SMEs), Non-Profit Organisations, and pension funds. Some of the requirements are also included in the Johannesburg Stock Exchange (JSE) listing rules

1 https://www.iodsa.co.za/page/king-iv

2.3. UK Corporate Governance Code

The latest version of this Code was issued in 2018 and its key principles are:

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders

In the UK companies with a premium listing are required to comply with the Code or explain where they have not applied the principles. This 'comply or explain' approach differs from the 'apply and explain' in the King Report. UK companies with a premium listing are expected to meet the highest standards of corporate governance and regulation.

The Code is principles-based so that it can be flexible and applicable to changing circumstances and events. Nigeria's Code of Corporate Governance, for example, is also principles-based.

Practice question 1

What are the four corporate governance outcomes of the King IV Report?

You will find the answer at the end of the chapter.

3 Defining roles and responsibilities for corporate governance

Introduction

In small companies the distinction between the owners and those who run the business can be irrelevant. Shareholders can be directors who are involved in day-to-day operations. In larger organisations, however, the distinction is important, and in this section we shall consider the different roles and responsibilities of those charged with corporate governance and the management of an organisation.

3.1. Those charged with governance (TCWG)

Definition:
THOSE CHARGED WITH GOVERNANCE

Those charged with governance: persons responsible for overseeing strategy and accountability, including the financial reporting process.

Those charged with governance, usually the board of directors, are accountable to the owners (or shareholders) and the wider stakeholders in the company, and have the following responsibilities:

- Accountable to the owners/shareholders for the organisation's performance
- Fiduciary duty of stewardship
- Ensuring the organisation complies with laws and regulations
- Supervision, direction and control of the entity
- Setting the strategy and objectives for the short, medium and long term
- Allocating resources to achieve objectives
- Demonstrating achievement of the objectives set
- The financial reporting process
- Approving the financial statements
- Organisational policies
- Delegating operational powers to management
- Monitoring the work of management
- Keeping track of the 'big picture' and setting the 'tone from the top'
- Externally accountable to investors, owners and other stakeholders
- Appointing additional members to the board of directors, such as NEDs
- Appointing the audit committee

However, some or all of these responsibilities are delegated by the board of directors to board sub-committees or the management of the entity.

3.1.1. Board committees

The board of directors of very large and complex companies appoints and delegates some of its responsibilities to many other board sub-committees. These committees manage aspects of corporate governance and report back to the main board. For example:

- The nomination committee leads the process for the appointment of directors to the board and ensures that there are succession plans for directors and senior management
- The risk committee reviews and reports on the company's internal financial controls and risk management systems
- The remuneration committee is made up of independent non-executive directors and determines the levels of salary and other benefits for board directors

One of the most important Board committees is the audit committee, discussed in the next section.

3.1.2. Audit committees

Corporate governance codes such as the UK Code referred to in Section 2.3. above, contain principles relating to roles and membership of an audit committee. The audit committee should be formed of a minimum of three non-executive directors (NEDs) at least one of whom should have relevant financial knowledge and experience. NEDs do not have executive responsibilities and are not involved in the day-to-day management of the company. They are therefore considered to be independent of the board of directors.

The audit committee is part of the arrangements for ensuring transparency in corporate reporting, risk management and internal controls. The terms of reference for audit committees should include:

- Monitor the integrity of the financial statements
- Advise the board on whether the annual report and accounts are fair, balanced and understandable
- Review and monitor the effectiveness of internal controls and risk management
- Recommend the appointment and remuneration of the external auditor
- Monitor the independence and objectivity of the external auditor, and the effectiveness of the external audit process
- Develop a policy on the provision of non-audit services by the external auditor to ensure that independence and objectivity are not compromised
- Review and monitor the work of internal audit
- Where there is no internal audit function, consider annually whether there is a need for one

The advantages of having an audit committee include:

- Improve the quality of financial reporting
- Reduce the risk of fraud
- Independent view provided by NEDs
- Forum for finance director to raise concerns
- Strengthen role of external auditor
- Forum for external auditor to raise issues independently of management
- Framework for ensuring audit independence in the event of disputes with management
- Strengthen the position of internal audit within the organisation
- Increase public confidence in the organisation

From an audit perspective the existence of an audit committee:

- Improves communication
- Provides a reporting line
- Establishes the importance of audit in the organisation
- Safeguards against threats to auditor independence
- Provides a means of raising concerns.

3.2. The role of management of the entity

Definition:
MANAGEMENT

Management: persons with executive responsibility for the entity's operations.

The responsibilities of management are delegated from those charged with governance (the Board), and they include the following:

- Senior oversight functions for departments and staff
- Staff recruitment and supervision
- Preparing the financial statements
- Design, implementation and monitoring of internal controls
- Day-to-day operational responsibilities
- Internally accountable to those charged with governance
- Designing policies and procedures to achieve strategic objectives
- Carrying out the strategy, decisions and policies of those charged with governance

4 Corporate social responsibility and environmental social governance

Introduction

So far in this chapter we have looked at corporate governance from the point of view of shareholders and other mainly economic stakeholders of organisations. The primary aim of a company is to create value for its shareholders by generating profits and paying dividends, thereby increasing shareholder wealth.

However, companies also have an obligation to abide by the laws and regulations that protect their customers and their employees. In this section we shall consider what businesses are doing to emphasise their ethical credentials and to demonstrate their benefits to a wider range of stakeholders that encompass society as a whole.

4.1.

Definition:
CORPORATE SOCIAL RESPONSIBILITY (CSR)

Corporate social responsibility

Corporate social responsibility (CSR): a business model designed to improve the image and the brand of the company by demonstrating a commitment to society and the environment.

Note from the definition that this is a business model rather than a regulatory or legal requirement. It is largely self-regulating although there is an increasing demand for comparable and meaningful reporting of CSR. Some companies voluntarily produce an integrated report that incorporates the 'triple bottom line' of profit, people and planet, identifying ways of reducing environmental risks and reducing, for example, carbon emissions. This takes into account the economic, social and environmental impact of the business. Integrated reporting is mandatory in South Africa for listed companies.

Companies can demonstrate their commitment to CSR with various initiatives, including:

- Reducing carbon footprint
- Reducing waste and emissions
- Responsible sourcing such as fair trade
- Commitment to human rights
- Employee engagement
- Ethical labour policies
- Charitable donations
- Supporting volunteering projects
- Community engagement
- Supporting local businesses
- Transparent payment of taxes

The benefits to business vary depending on the type of business and the CSR initiatives in place. Examples include:

- Improved brand recognition and reputation
- Customer loyalty
- Increased sales
- Cost savings from reducing waste in operations
- Employee loyalty
- Attracting talent
- Attracting finance and investment
- Reduced regulatory burden and sanctions

Care should be taken to ensure that CSR initiatives are genuine and not a cynical exercise or a publicity stunt. Customers and investors are quick to react negatively if the perception is seen to be short-term gain rather than a long-term, demonstrable commitment to social responsibility.

Companies should also be aware of potential conflict between investors' desire for profits and dividends, which is the core purpose of the business, and the needs of society as a whole.

Corporate social reports are normally part of a company's annual report and contain an explanation of the company's policies, achievements to date and future plans. Typical sections of the report would include:

- Sustainability report
- Sustainable development policy
- Environmental reporting (targets and results for waste management, recycling and reduction in plastic usage)
- Community projects (supporting local communities, volunteering, supporting local communities)
- Information on support given to local businesses
- Information on the use of ethically sourced materials in manufacturing

The aim of the report is to provide transparency and show how the company is operating ethically and responsibly. Increasingly there is a shift from corporate social reports to sustainability reports, the latter focusing on the future growth and survival of the organisation while supporting the environmental, social and economic elements that are reported on in CSR.

4.2. Environmental social governance

As we have seen in Module 5, Financial Accounting, sustainability is the ability to meet present needs without compromising the needs of future generations.

Definition:
ENVIRONMENTAL SOCIAL GOVERNANCE (ESG)

Environmental social governance (ESG) is a framework that helps investors and stakeholders assess how sustainable an organisation's operations are. It also helps stakeholders to understand how an organisation manages risks and opportunities around sustainability (environment, social and economic) issues.

Whereas CSR is a voluntary business model used by individual companies, ESG represents a framework of measurable criteria used by investors to measure how sustainable an organisation's operations are. It also helps stakeholders

to understand how an organisation manages risks and opportunities around sustainability (environment, social and economic) issues. The demand for ethical or socially responsible investment is growing globally and companies are assessed on the sustainability of operations and the ethical impact of the business.

The key elements of ESG are summarised in the table below.

Table 2. Key elements of ESG

Planet (environmental)	People (social)	Governance
▣ Waste and pollution ▣ Depletion of natural resources ▣ Greenhouse gas emissions ▣ Deforestation ▣ Climate change	▣ Employee relations and diversity ▣ Working conditions ▣ Local communities ▣ Health and safety ▣ Conflict	▣ Tax strategy ▣ Executive remuneration ▣ Donations and political lobbying ▣ Corruption and bribery ▣ Board diversity and structure

Companies that can demonstrate a long-term commitment to sustainability and having a positive impact on society and the environment are more likely to attract investment from the growing numbers of investors who to see an ethical return rather than simple financial enrichment.

Self-study 2.

If you have access to the internet, try to have a look at some reports published by some well-known companies, such as:

- ▣ De Beers Group
- ▣ First Quantum Minerals Ltd
- ▣ Walt Disney
- ▣ Cisco
- ▣ General Motors
- ▣ IBM

You will note that there is no consistency in the wording of the titles, with CSR/ESG/ sustainability being used almost interchangeably. You will also note that they are visually attractive and vary in structure, because there is no globally recognised standard for these types of reports.

Organisations are preparing ESG/ Sustainability reports to communicate their performance and impact on a wide range of sustainability topics that include environmental, social and governance. The reports are used by stakeholders to assess the material sustainability-related risks and opportunities relevant to the organisation.

The investors and stakeholders are increasingly calling for consistent and comparable sustainability information. This is what has resulted in the establishment of the International Sustainability Standards Board by International Financial Reporting Standards Foundation to develop a global baseline of sustainability disclosure standards. Organisations will use these standards to prepare sustainability/ESG reports.

4.3. Assurance of CSR and sustainability reports

The increasing expectation that organisations in both the public and private sectors should produce sustainability reports has led to the development of forms of reporting other than the traditional audit report on financial statements.

This is known as **extended external reporting (EER)**. EER includes information about both the financial and non-financial consequences of an organisation's activities. It may be historical or forward-looking and can focus on either the organisation's own resources and relationships, or the wider state of the economy, the environment and society, or both elements.

Extended External Reporting (EER) assurance describes engagements to provide assurance on different forms of non-financial reporting, including integrated reporting, sustainability reporting and non-financial reporting about environmental, social and governance matters. This development shows how the role of the auditor is extending beyond the simple evaluation of and reporting on financial information. In 2021 the IAASB published guidance for EER assurance engagements. This is a rapidly-developing area of assurance of which you should be aware.

4.4. Sustainability reporting in the public sector

The public sector forms a large part of most economies and has a wide impact on society and the environment.

Climate change (environment) is as much of a threat to the public sector as it is to the private sector. Governments are increasingly incorporating climate change in their policies and programs and developing systems to measure and report climate change risks and opportunities.

Definition: **ENVIRONMENTAL FOOTPRINT**

Environmental footprint: the impact of human activity on the environment, measured by:

- Consumption of natural resources
- Harm caused by pollution

Commitments to social responsibility and sustainability in the public sector can be summarised as follows and can form the basis for sustainable reporting in the public sector:

Table 3. Commitments to social responsibility and sustainability in the public sector

Environmental	People	Procurement	Community
▣ Reduce impact of activities ▣ Reduce waste and emissions ▣ Reduce depletion of natural resources	▣ Diversity ▣ Equal opportunities ▣ Professional development ▣ Health and safety and wellbeing	▣ Sustainable procurement ▣ Fair trade	▣ Promote volunteering ▣ Fundraising ▣ Support local business ▣ Support local communities

Reporting on sustainability in the public sector has lagged behind the private sector. However, progress is being made by the International Public Sector Accounting Standards Board[2] in developing a global standard for sustainability reporting in the public sector, based on the global reporting standards of the International Sustainability Standards Board (ISSB).

Self-study 3.

What are the main environmental and social concerns in your country at the moment? What are the solutions being proposed by government, other agencies or activists?

You will find some suggestions at the end of this chapter.

2 https://www.ipsasb.org/publications/exposure-draft-ed-83-reporting-sustainability-program-information

Chapter summary

You should now be able to:

- Explain the importance of corporate governance in organisations
- Explain the role of the audit committee
- Explain the importance of corporate social responsibility (CSR) environmental social governance (ESG) and sustainability for organisations
- Describe sustainability in the public sector

Please check your understanding by attempting the self-test questions below.

Self-test questions

1. What is corporate governance?
2. Give an example of a recognised corporate governance code.
3. What are NEDs? How and why do they play an important role in audit committees?
4. Which of the following is the responsibility of management?
    1. Setting strategic objectives
    2. Preparing financial statements
    3. Approving the financial statements
5. State TWO social aspects of the ESG approach.

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 20.1 to 20.16
- Questions 21 and 22

Answers to practice questions

Answer to Practice Question 1

The four outcomes of the King Report are:

- Ethical culture
- Good performance
- Effective control
- Legitimacy

Suggested answers to self-study questions

Answer to Self-study 3

What are the main environmental and social concerns in your country at the moment?

- Climate change – this is a global issue
- Food security – loss of crops and farmland to drought and wildfires
- Water shortages and pollution of water sources
- Deforestation by logging
- Destruction of the natural world by mining, gas and oil extraction, and growing populations
- Health crises – recent global pandemic
- Energy costs
- Plastic waste

What are the solutions being proposed by government, other agencies or activists?

- Investment in renewable energy
- Eco-friendly policies
- Zero carbon programmes
- Vaccination programmes
- Waste management and recycling
- Promoting a green economy

CHAPTER 7

Public sector assurance

Introduction

Professional accountants and assurance providers work in a variety of organisations in both the public and private sectors of the economy. In this chapter we shall be looking at some of the differences between these two sectors and how these differences influence the approach to assurance and reporting.

The public sector plays an essential role in developing communities through the provision of public goods that benefit society as a whole. At the same time the public sector provides equal opportunities in the pursuance of wealth creation and development by individuals and companies in the economy.

The public sector varies widely from country to country, and the examples provided are for illustration only. You may find it helpful to try to research how the public sector is governed and how it operates in your own country.

In this chapter we will learn about

- Types of public sector organisations
- Stakeholders and regulation of the public sector
- Forms of assurance and reporting
- Internal controls
- ISSAIs

Learning Outcomes

On completion of this chapter, students should be able to:

Reference	Learning Outcome
8.1, 8.2	Form of assurance and reporting. Describe the requirements of stakeholders in the public sector and explain how they are different from the private sector
8.3	Explain why the focus of internal controls may differ in the public sector
8.4	Explain the role of International Standards for Supreme Audit Institutions (ISSAIs)
8.2	Explain why obtaining value for money is important in the public sector and demonstrate how value for money is achieved

Exam awareness

Although the principles of assurance are similar between the private and public sectors, there are important differences that you should be aware of. In the exam you should read the question carefully so that you prepare your answer accordingly.

1 Public sector organisations

Introduction

In this section we will define what is meant by the public sector and consider the type of organisation that is public rather than private in nature.

1.1. What is the public sector?

Definition:
PUBLIC SECTOR

Public sector: a part of the economy that is owned and operated by the state, consisting of organisations that provide services to the population.

As you have seen in your studies of Module 3, Business Skills, the public sector generally refers to services provided by the government, either directly from central government or through regional or local authorities. Such services can be funded through taxation, duties on goods and services, government borrowing, or through international aid.

The public sector is the sector of the economy that provides services for general use by everybody. Such services enhance the overall welfare of the population and promote their social, economic and political lives.

In Africa public services can be provided by national, provincial, local or municipal government, or by state-owned entities (SOEs). Across the continent the role of local authorities and public-private partnerships in the provision of public services is growing, as is the involvement of civil society in the public sector.

In African countries, the public sector plays a fundamental role in socio-economic development. It is also responsible for providing much of the infrastructure needed for development. It provides the largest single source of employment in many African countries.

Self-study 1.

Before we go any further, list some of the public services provided by government in your own country.

You will find some suggestions at the end of this chapter.

Answers to this question will differ widely but the following are some examples of public services:

- Defence (army, air force)
- Health (doctors, hospitals)
- Education (schools, libraries)
- Transport infrastructure (roads, bridges, airports)

- Utilities (electricity, gas, water)
- Emergency services (fire, ambulance)
- Law enforcement (police)
- Social housing
- Waste management (rubbish collection, street cleaning)
- Social services
- Postal services
- Tax collection authorities
- Licensing authorities

Some services are provided free of charge at the point of use, for example domestic waste collection and libraries. Others have to be paid for, such as postal services. In some economies there can be a combination of public and private provision, for example free schooling provided by the state alongside private schools that charge a fee.

Public goods and services benefit society as a whole and represent those areas that cannot easily be supplied by a free market.

The development of the public sector in Africa has been hampered since the economic crises of the 1990s, which led to an increase in international debt across the continent. Paying back the loans incurred means that funding is limited, and this situation is made worse by the difficulties faced by many countries in collecting taxes that are due to the state.

The African Union recognises the importance of the public sector in the development of the continent:

> *When reinforced, good governance and public service facilitate health communities, government accountability, constructive and positive citizen engagement, job creation, and lay the framework for development and growth. On the other hand, weak public services result in education gaps, citizen distrust, and a lack of government transparency.*
>
> *- African Union*[3]

There is public demand for improvements in healthcare, education, justice, safety and security, and for a reduction in corruption, which can prevent citizens from accessing public services.

As part of your studies, you should familiarise yourself with the public sector in your country, and, where possible, compare it with other countries both within Africa and in other parts of the world.

3 https://auti.africa/industries/government-and-public-services/

1.2. Differences between the public and private sectors

The public sector exists to benefit society and to provide essential services to the community, either free or at subsidised rates. Its organisations are owned by the state, under the direct control of government, and are not designed to be profit-making.

The private sector, on the other hand, is funded and owned by shareholders, and its main purpose is to make a profit for those shareholders. Shareholders can be individuals, commercial organisations or governments, and their aim is to see an increase in their investments.

Practice question 1

What is the main difference between services provided by the state and good and services sold by private sector businesses?

You will find the answer at the end of the chapter.

2 Public sector stakeholders

Introduction

The role and influence of the state affects the population as a whole and policy decisions have far-reaching consequences. The range of stakeholders is therefore much wider than in the private sector.

2.1. Who are public sector stakeholders?

As we have seen previously, the main stakeholders in private companies are the shareholders who own the company. These shareholders are concerned with the value of their shares in the market, profits made by the company and dividends paid out. They are also concerned with how the company is managed and with the continuing success of the business.

In the public sector we could count everybody in the country as 'owners' of the various organisations established by government for the public good. Other stakeholders are similar to those of private companies, for example:

- Employees
- Suppliers
- Regulators
- Trades unions

For the public sector we could add the following to the list:

- Citizens or subjects
- Politicians
- Taxpayers
- Donors

The key difference is that stakeholders in the public sector do not have a range of providers to choose from, and they cannot determine the rate at which they are charged for services. There is little or no opportunity to shop around for the best price or the best product. It is very important therefore that the public sector is fair, equitable and transparent, and that taxation is also fair and progressive. .

3 Assurance and reporting in the public sector

Introduction

The parties involved in public sector assurance are similar to those in the private sector in that there is a three-way relationship between the principal, agent and practitioner.

Due to the fact that they are publicly-funded or donor-funded, public sector entities may undergo other types of audit as well as a financial audit, for example a compliance or performance audit.

3.1. The three parties in public sector assurance

As we have already seen for the private sector, there are three parties involved in assurance arrangements.

The principal, or the users, in the public sector represent a wider group than company shareholders and can include any or all of the stakeholders noted above.

The agent is represented by the officials who are responsible for the stewardship of public funds and for implementing the policies of government, for example government ministries.

The practitioner carries out the assurance work and provides independent assurance to the users about the activities of the responsible parties. In the public sector the practitioner is very often the Auditor General, although in some countries a private sector audit firm may be permitted to carry out audits of public sector entities.

3.2. Appointment of public sector auditors

The audit of public sector organisations is usually a statutory requirement and is part of the responsibility of the office of Auditor General or equivalent public appointee.

The auditors of companies in the private sector are appointed by the shareholders (the owners of the company) and report to the shareholders in an independent auditor's report. In practice, the directors usually decide who the auditors should be and propose them to the shareholders accordingly. As we have seen, the 'owners' or stakeholders in the public sector are a broader classification, including the public as a whole.

Precise requirements for the appointment of auditors in the public sector vary by country. The law specifies the auditor, mainly the Auditor General and the timeline for the audited financial statements to be submitted to Parliament by the Auditor General or the Ministry of Finance.

In some cases, a public body could have the autonomy to appoint its own auditor in much the same way as a private company. Other organisations in the public sector can be audited by a public body appointed by the government and reporting to the legislative body, for example to a cross-party public accounts committee. In Nigeria, for example, the Auditor General's Office is responsible for all aspects of audit, including the appointment of audit firms for the audit of government agencies, for inclusion in the relevant ministry's report in the audited financial report.

You should research the arrangements in your country and compare them to those in other countries. Here are a couple of examples of national government auditors:

- In Zambia the Office of the Auditor General is the Supreme Audit institute mandated to audit all government institutions, statutory boards, donor funded agencies and any other institute in which public resources have been invested.
- In Nigeria, the Office of the Auditor General of the Federation is a constitutional body and the supreme audit institution of Nigeria. It is empowered to undertake audits of all income and expenditure of the Federal Government of Nigeria. Each of the 36 states of Nigeria has two Auditors-General, one for the audit of state institutions and the other for the audit of local governments within the state. In total, there are 73 Auditors-General in Nigeria, more than the whole of the rest of Africa put together.

Outside Africa, two examples for comparison are:

- The European Union Court of Auditors which passes judgements on the accounts
- The United Kingdom's Comptroller and Auditor General, who reports to Parliament on government departments

In Module 9, Public Sector, you will learn more about the operation of public sector audit in your own country.

3.3. Wider responsibilities in public sector audit

Specific arrangements in different jurisdictions will vary, but these are some of the additional matters that may be relevant in a public sector audit:

- Compliance with ministerial directives, government policy or resolutions of the legislature
- Activities are permitted within the powers vested in the organisation. This is sometimes expressed with the Latin phrase 'intra vires' which means 'within the powers'; activities that are beyond the organisation's powers are 'ultra vires'
- Expenditure is in accordance with legislation
- Good financial management arrangements are in place
- Audit of grant claims
- Performance audit reporting on Key Performance Indicators
- Value for money audit
- Investigations into mismanagement of public funds
- Lower materiality level for fraud and corruption
- Respond to concerns raised by the public
- Report on matters relating to the public interest
- Report to donor organisations

Two specific types of audit are used to achieve some of these wider objectives: the compliance audit and the performance audit.

3.4. Types of public sector auditing

This section introduces some of the key types of audit in the public sector. The objective of several of them is to assess whether the organisation is achieving value for money.

3.4.1. Financial statement audits

Private sector companies are often required by law to have an annual audit of their financial statements. Public sector organisations will also produce financial statements, and local legislation might determine that they too require an annual audit. In Nigeria, for example, the law requires that the audited financial statements of government must be ready for publication within four months of the accounting year end.

The overall objectives of the audit, as set out in ISA 200, are similar. The auditor should obtain reasonable assurance that the financial statements are free from material misstatement, and should communicate their findings in an independent

report. The standard recognises that the mandate for a public sector audit may be broader and may include responsibility for ensuring that transactions are in accordance with the law or regulation. We shall now look a little more closely at these wider responsibilities.

3.4.2. Compliance audits

A compliance audit is a formal review of an entity's processes and operations, generally to ensure compliance with internal and external regulations. This can cover any area of operations, for example a construction company may undergo a compliance audit to ensure that it complies with health and safety and environmental regulations. Providers of funding may impose a requirement for a compliance audit to be carried out on the recipient at intervals during the project.

3.4.3. Performance audits

A performance audit is an assessment of an entity's operations to review whether specific functions are working as intended to achieve goals and targets set. They can be performed by either internal or external audit teams. They are particularly common in government agencies given that so many of them receive public or donor funding. For example a performance audit may review an entity's procurement processes in order that they function as they should.

One type of performance audit is the value for money audit, which may also be referred to as an operational audit or management audit. The focus is on the systems put in place by management to achieve value for money and involves non-financial systems. A wider variety of the organisation's staff and management are included in questioning and information gathering than in a financial statements audit.

The concept of value for money is discussed in further detail in Section 4 below.

3.4.4. Performance information audits

Performance information describes the comparison of performance against pre-determined objectives or goals. Examples include average times for patients to wait for hospital appointments or average attendance levels at schools.

Performance information typically forms part of the evidence of a wider-ranging value for money (VFM) audit, aiming to provide an opinion on the extent of achievement of an organisation's operations against the efficient, effective and economic criteria normally associated with public sector performance management.

3.4.5. Environmental audits

Organisations that produce CSR, ESG or other sustainability reports can choose to have an environmental audit, and this is often a requirement for organisations in the public sector.

At the moment there is no globally recognised format for such a report and there are no standards such as ISAs that cover environmental auditing. However INTOSAI (the International Organisation of Supreme Audit Institutions, covered in more detail in section 6.1 below) has published guidelines for the conduct of environmental audits.

Environmental audits can be carried out by a company's internal or external auditors or by another practitioner.

Definition: **ENVIRONMENTAL AUDIT**

Environmental audit: a systematic examination to assess a company's environmental responsibility. An environmental audit examines the potential hazards or risks posed by the company to the environment, human health and safety, and assesses the company's commitment to minimising harm to the environment.

Note that an environmental audit is different from an environmental impact assessment. An environmental impact assessment looks at the potential environmental impact of a proposal, policy or development. It is undertaken before the development takes place, whereas an environmental audit examines existing operations.

In the absence of globally recognised criteria, some companies base their environmental audits on the seventeen Sustainable Development Goals agreed by the member states of the United Nations. These goals are:

1. No poverty
2. Zero hunger
3. Good health and wellbeing
4. Quality education
5. Gender equality
6. Clean water and sanitation
7. Affordable and clean energy
8. Decent work and economic growth
9. Industry, innovation and infrastructure
10. Reduced inequalities
11. Sustainable cities and communities
12. Responsible consumption and production
13. Climate action

14. Life below water
15. Life on land
16. Peace, justice and strong institutions
17. Partnerships for the goals

Not all of these will be relevant for all companies or organisations so they can focus on those where they do have some impact. Typical areas covered in an environmental audit are: energy use, recycling, waste, conservation, and pollution.

Example 1.

Goal: reduce carbon footprint by 20%

Measures:

- Use of renewable energy
- Enable working from home
- Avoid unnecessary travel by having web-based meetings
- Web-based business
- Reduce paper usage and waste by:
  - Printing less
  - Using digital forms
  - Digital file storage
  - Digital reporting
  - Using recycled paper

Environmental auditors will look at the policies and procedures that a company has put in place to meet environmental goals, and to comply with regulations. They will identify risks of non-compliance and make recommendations for improvement where necessary.

4 Value for money

Introduction

Businesses can evaluate success in achieving objectives in a number of ways, such as profitability, increasing market share, the value of shares or customer feedback. In the public sector, which is not-for-profit, performance against objectives can be measured by a value for money analysis.

You have seen in the previous paragraph that the focus of some types of public sector audits is on evaluating value for money achieved by an organisation.

4.1. The three 'E's of Value for money

The three 'Es' of value for money are economy, efficiency and effectiveness. We shall now look at each of these in turn.

Definition:
ECONOMY

Economy: the inputs into a process measured in monetary terms.

Economy means obtaining resources at the lowest possible cost whilst maintaining quality. Inputs can usually be easily measured because they are purchased by the organisation. Examples of inputs include the following:

- Rent of buildings
- Salaries
- Stationery
- Vehicles
- IT equipment
- Capital expenditure
- Administration

Example 2.

If we take a public hospital as an example, inputs include salaries of medical and administrative staff, purchase of beds and medicines.

The second element of value for money is efficiency.

Definition:
EFFICIENCY

Efficiency: the relationship between the inputs and outputs of a process or service.

Efficiency is achieved by either minimising the inputs for a given level of output, or maximising the outputs for a given level of inputs. Where the level of outputs is the determining factor, efficiency is achieved though achieving these outputs with the minimum level of inputs. Inputs such as staffing and facilities are often finite, so efficiency is achieved though making the most of these inputs.

Examples of outputs for public services include the following:

- Number of emergency calls responded to
- Number of children in school
- Number of streets cleaned
- Coverage of street lighting
- Miles/kilometres of roads built

Example 3.

In our hospital example, efficiency measures include number of patients seen in clinics, number of operations performed, and number of prescriptions dispensed.

The final element we shall consider is effectiveness.

Definition:
EFFECTIVENESS

Effectiveness: the extent to which stated objectives are achieved.

Note that the definition specifies that stated objectives are achieved. These will be the objectives stated in government policy or in a specified programme, and effectiveness considers whether the expected outcomes have been achieved in terms of quality as well as quantity. Effectiveness can be difficult to measure as the outcomes are not always quantifiable and there can be conflict between policies and programmes.

Examples of effective outcomes include:

- Improvement in school grades
- Reduced rates of diabetes
- Reduced fatalities on roads
- Reduction in crime
- Improved well-being indicators

Example 4.

Effectiveness in a public hospital includes improved survival rates following surgery or fewer repeat prescriptions.

Two more aspects of value for money are relevant in the context of public services: equity and ethics. **Equity** refers to public money being spent fairly and equitably, and **ethics** assesses integrity, openness and transparency in the use of public funds.

5 Internal controls and governance in the public sector

Introduction

This section will look at aspects of internal controls and governance that are of relevance to the public sector.

Definition:
INTERNAL CONTROLS

Internal controls: processes that help to ensure that an organisation meets its objectives. They ensure that financial systems comply with laws and regulations and aim to prevent weaknesses that can lead to fraud, error or misstatement.

Definition:
GOVERNANCE

Governance: the system that determines how organisations are directed and controlled.

5.1. Internal controls in the public sector

ISA 315 recognises that auditors in the public sector need to have a broader and more detailed consideration of the system of internal controls. This is because they might have specific reporting duties, for example with regard to compliance with established practice, spending against budget, compliance with law, regulation or policy.

As well as considering controls relating to the financial statement assertions, public sector auditors will evaluate controls over wider objectives, for example:

- Obtaining value for money – the organisation is ensuring economy, efficiency and effectiveness in the use of resources
- Regularity – the organisation is acting within the powers granted by law
- Validity – no payments are made to false employees or suppliers
- Substance – transactions are supported by the underlying documentation
- Timeliness – data is recorded promptly
- Security – physical and electronic data are held securely and privacy is protected
- Authority – policies, codes and regulations are followed at all times
- Propriety – activity and transactions are ethical and are conducted with integrity

Practice question 2

The system for paying teachers in a government-run school has controls in place to ensure that salaries are paid promptly and that the personal details of teachers and pay grades are kept securely.

Describe a control that could be put in place to meet these objectives.

1. Timeliness:
2. Security:

You will find the answer at the end of the chapter.

5.2. Governance in the public sector

Good governance is as important in the public sector as corporate governance arrangements are in the private sector, and the same fundamental principles apply. Effective leadership and direction help to ensure that the organisation's objectives are met in a responsible and ethical way.

Public governance arrangement must take into account a variety of stakeholders and strike a balance between the needs of taxpayers and the users of public services. The focus should be on:

- Leadership – a clear vision of the organisation's objectives and the management of risk

- Effectiveness – employing experienced personnel and challenging performance
- Accountability – accounting and reporting methods that promote transparency
- Sustainability – maintaining a long-term view on the direction of travel

The duty of the auditor is to determine compliance with codes of governance in place for the organisation and to report on any divergence.

5.3. Principles of public life

In many countries principles of public conduct are recognised and applied. These principles recognise that holders of public office are both servants of the people and stewards of public resources, and are accountable to a wider community of stakeholders than officers of, for example, private companies.

The seven general principles are:

- Selflessness – acting solely in the public interest
- Integrity – avoiding inappropriate influence or obligation and declaring any interests and relationships
- Objectivity – making decisions impartially, fairly and on merit, without discrimination or bias
- Accountability – being accountable to the public for decisions and actions
- Openness – making decisions in an open and transparent manner
- Honesty – being truthful at all times
- Leadership – promoting these principles in their own behaviour, treating others with respect, and challenge poor behaviour when it occurs

In the UK the Seven Principles of Public Life (known as the Nolan Principles) apply to all holders of public office, including elected representatives, the civil service, local government, and public sector services.

6 International Standards for Supreme Audit Institutions (ISSAIs)

Introduction

ISSAIs are international standards on public sector auditing and are part of the International Organisation of Supreme Audit Institutions (INTOSAI) Framework of Professional Pronouncements (IFPP).

Definition:
SUPREME AUDIT INSTITUTIONS (SAIs)

Supreme Audit Institutions (SAIs): the external auditors of national governments. They are government entities whose external audit role is established by the constitution or supreme law-making body.

6.1. INTOSAI

INTOSAI is an autonomous, independent, professional, and non-political organization established to:

- provide mutual support;
- foster the exchange of ideas, knowledge, and experiences;
- act as a recognized voice of SAIs within the international community;
- provide high quality auditing standards for the public sector;
- promote good governance; and
- foster SAI capacity development and continuous performance improvement.[4]

INTOSAI actively promotes good governance in the public sector and aims to fight corruption and improve public trust in organisations that benefit citizens. The independence of SAIs is one of the founding principles of INTOSAI who state that this independence should be established in a country's constitution.

6.2. ISSAIs

INTOSAI states that: the purpose of ISSAIs is to:

- Ensure the quality of the audits conducted
- Strengthen the credibility of the audit reports for users
- Enhance transparency of the audit process
- Specify the auditor's responsibility in relation to the other parties involved
- Define the different types of audit engagements and the related set of concepts that provides a common language for public sector auditing.

ISSAIs are based on International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) and they have the same number preceded by a '2'. ISA 200 is therefore ISSAI 2200 and so on.

For further information see INTOSAI website.[5]

4 Source: https://www.intosai.org/about-us
5 https://www.intosai.org

Chapter summary

You should now be able to:

- Explain the differences between the public and private sectors
- Identify stakeholders in the public sector
- Describe the forms of assurance and reporting in the public sector
- Explain the importance of value for money
- Explain the focus of internal control in the public sector
- Explain the role of ISSAIs

Please check your understanding by attempting the self-test questions below.

Self-test questions

1. List THREE key differences between the private and the public sectors
2. Audit in the public sector has a narrower mandate than in the private sector. Is this statement TRUE or FALSE?
3. What is the meaning of corporate governance in the public sector?
4. What is a Supreme Audit Institution (SAI)?
5. In Value for Money (VFM) which 'E' refers to the extent to which stated objectives are achieved?

The answers to these questions can be found at the end of the book

You should now attempt the following questions in the Question Bank:

- MCQs 25.1 to 25.8
- Questions 26 and 27

Answers to practice questions

Answer to Practice Question 1

The main differences is that public services provided by the state can be provided free of charge at the point of use.

Answer to Practice Question 2

1. Timeliness:
   - Timesheets are signed and submitted for payment on the last day of each month by teaching supervisors.
   - Payroll is authorised for payment by the head of finance.
2. Security:
   - Documents are held under lock and key with restricted access.
   - The payroll system is protected by passwords and access to personal data is restricted to senior personnel.

Answers to self-test questions

Chapter 1. The Concept of assurance

1. Reasonable assurance (higher level) and limited assurance (lower level).
2. The statement is FALSE. This is an example of a reasonable (but not absolute) assurance engagement.
3. The five elements are:
   - **C**riteria
   - **E**vidence
   - **R**eport
   - **T**hree-way relationship
   - **S**ubject matter
4. This is the difference between the public or popular perception of what auditors do and what their legal and professional responsibilities actually are.
5. Professional scepticism.

Chapter 2. Internal controls

1. **C.**
2. **B.**
3. **A.**
4. **D.**
5. The statement is **FALSE**.

Chapter 3. Deficiencies in internal control and remedies

1. Reperformance is when the auditor carries out an internal control procedure independently.
2. False. Recalculation is a substantive procedure.
3. False. Auditors must always carry out some substantive procedures.
4. Both are substantive procedures.
5. Tangible costs can be quantified in monetary terms, intangible costs are not quantifiable.

Chapter 4. Fraud

1. The statement is FALSE. Fraud is always a deliberate act.
2. The correct answers are A and D. B and C are examples of misappropriation of assets.
3. The correct answer is D.

   A, B, and C are risk factors associated with fraudulent financial reporting.
4. Management override of controls.
5. Management and those charged with governance.

Chapter 5. Ethics for the professional accountant

1. This is a self-interest threat to objectivity.
2. Professional competence and due care.
3. False. It is a principles-based Code.
4. Intimidation threat.
5. Confidentiality.

Chapter 6. Corporate governance and corporate social responsibility

1. The system by which companies are directed and controlled.
2. OECD Principles, King Report, UK Corporate Governance Code, national codes.
3. Non-executive directors have no executive powers and are not involved in day-to-day management. Their role in the audit committee is to be independent of the board of directors.
4. 2 only. The others are the responsibilities of those charged with governance.
5. Any two of:
   - Employee relations and diversity
   - Working conditions
   - Local communities
   - Health and safety
   - Conflict

Chapter 7. Public sector assurance

1. Suggested answer:

Private sector	**Public sector**
Profit-making	Non-profit-making
Owned by shareholders	Owned by government/the public
Funded by investment	Funded by taxation
Market-driven	Politically motivated

2. The statement is FALSE. The mandate of audit is wider in the public sector, not narrower.
3. Corporate governance is the way in which organisations are directed and controlled. This applies to the public sector as well as the private sector.
4. A Supreme Audit Institution (SAI) is the auditor of a national government.
5. Effectiveness.