

## TOPIC 1: NATURE, PURPOSE AND CLASSIFICATIONS OF AUDITS

- **Auditing** is an independent examination of the books of accounts, vouchers and records of the entity by an independent professional auditor to express an opinion on whether the financial statements reflects a true and fair view and have been prepared in accordance with the identified financial reporting framework.
- Auditing is an assurance engagement of which an auditor issues a report which is ultimate product of expressing his opinion on the financial statements.

ACCOUNTING	AUDITING
Recording, classifying, and summarizing financial transactions to create financial statements.	Examining and verifying the financial statements prepared by accountants.
Ongoing routine and continuous. Done every day throughout the year.	Periodic and independent. Done quarterly or annually after the accounting period ends.
Broad. Covers all financial transactions to create a complete picture.	Specific. Focuses on the accuracy and validity of the financial records and statements.
Employee of the company. Works for management.	Independent external party (External Auditor). Works for the shareholders.
Accounting Standards (e.g., GAAP, IAS, IFRS)	Auditing Standards (e.g., GAAS, ISA).

### Objectives of an audit of financial statements

- a) Primary objective
- b) Secondary objective

#### a) Primary/Statutory/Company's Act objective

- ✓ The primary objective is to enable the auditor to express an opinion on whether the financial statements give a true and fair view and have been prepared in accordance the financial reporting framework.
- ✓ Whether financial statements portray a true and fair view
- ✓ Whether the accounting policies have been used and have been applied consistently.
- ✓ Whether in their opinion and according to the explanations given to them, the financial statements gives information required by the company's Act in a manner so required. ✓  
Whether the financial statements are in agreement with the books of accounts.
- ✓ Whether in their opinion, proper books of account have been kept and proper returns have been received from branches not visited.

#### b) Secondary/Incidental objective

These are the objectives that are not compulsory but desirable and include the following:

- ✓ To detect, correct and prevent errors and frauds on timely basis.
- ✓ To advice the management regarding the ICS, accounting systems, tax and management issues through the preparation of the management letter.
- ✓ To assess efficiencies, effectiveness and economical use of resources ie 3E's.

- ✓ Report on any omissions or inconsistencies in other reports generated by the directors to the shareholders.

### **c) Professional body objectives**

- ✓ Upholding Public Interest and Trust- Enforcing strict codes of professional ethics that require independence, integrity, objectivity, and professional competence.
- ✓ Establishing and Maintaining Professional Standards- Creating standards for auditing (ASAs, ISAs, GAAS), quality control, review, and other assurance services. Also Continuously revising standards to address emerging issues (e.g., auditing complex financial instruments, digital assets, or considering climate-related risks)
- ✓ Ensuring Competence and Quality of Members- Setting the educational bar for entry into the profession, administering rigorous certification exams (like the CPA or CA exams) to ensure a baseline of knowledge, mandating ongoing education so members stay current with evolving standards, technologies, and business practices.
- ✓ Supporting and Developing Members- Hosting conferences, seminars, and forums for members to exchange ideas, Publications (Producing journals, magazines, and online content to keep members informed)

### **Expectation Gap**

This is the difference between the public perception on what auditors do and what auditors actually do.

Examples:

- ❖ The public thinks that it is the auditor's responsibility to detect and prevent frauds and errors.
  - ❖ The public think that auditor should report to the management.
- ❖ The public think that the qualified report is more favorable than unqualified report.
- ❖ The public thinks that auditors provide absolute assurance.

### **Elements or causes of expectation gap**

#### **1. Standard gap**

This gap arises where the public doesn't understand the auditing standards which provide framework around which an audit of financial statements is conducted.

#### **2. Performance deficiency gap**

This gap arises when the auditor's performance falls short of expectations of the professional and legal requirement which require the auditor to exercise professional skills and due care in audit of financial statements

#### **3. Liability gap**

The gap arises because the public does not understand legal responsibility of the auditor. **4.**

#### **Unrealistic expectation**

The public sometimes has over expectation from the auditors, for example, the public expect the auditor to be able to detect all errors and frauds, the public expect the auditor to provide absolute assurance.

#### **5. Standard deficiency gap**

This gap arises when the existing audit standards have not adequately addressed a unique situation that the auditor has encountered in the audit of the client.

### **Possible ways of eliminating expectation gap**

- 1) The auditor should communicate to the users of his report to enhance their understanding of the auditing.
- 2) The accountancy professional bodies such as ICPAK should conduct public seminars to educate the public on the role of auditors especially on matters regarding frauds and the fact that it is difficult to detect frauds.
- 3) The accountancy professional bodies such as ICPAK should take disciplinary actions against auditor who compromise on the quality of the audit.

### **Responsibilities of the management with regards to the financial statements**

- ✓ To prepare and present financial statements in accordance with the identified financial reporting framework.
- ✓ To design and implement strong and effective systems of controls that are relevant to ensure that financial statements are not materially misstated.
- ✓ To maintain proper books of accounts.
- ✓ To select appropriate accounting policies.
- ✓ To make reasonable accounting estimates
- ✓ To safeguard the company's assets by ensuring a proper record exists.
- ✓ To prevent and detect frauds and errors
- ✓ To file the relevant returns to the appropriate authorities
- ✓ Consider the appropriateness of going concern basis of accounting

### **Responsibilities of the auditor with regards to the financial statements**

The auditor's primary responsibility is to express an opinion on the truthiness' and fairness of financial statements and report in the manner prescribed by the law and professional framework.

The auditor must plan, document and perform the audit to obtain sufficient appropriate audit evidence which forms the basis of his opinion.

In his audit report the auditor should include the following:

- a) Whether the client company maintained proper books of accounts.
- b) Whether he received all the information and explanation that he considered necessary for the purpose of the audit.
- c) Whether he received all the returns from the branches
- d) Whether the books of accounts are in agreement with the financial statements.
- e) Whether the financial statements reflect a true and fair view and are prepared in accordance with the identified financial reporting framework.

### **CLASSIFICATION OF AUDITS**

- Audit are may be classified in a variety of ways.
- It may be classified based on the context of audit, person doing the audit, timing of the audit and even the purpose for which the audit is carried out.

***Classification of audits based on the context***

- Audit is broadly classified into either as **external audit** or **internal audit**.

**EXTERNAL AUDIT**

- Is carried out by an external appointed independent whose main purpose is to enable the auditor to express an opinion on truth and fairness of financial statements.
- Further classified into two:
  - 1) Public / statutory audit
  - 2) Private/non-statutory/voluntary audit

**PUBLIC / STATUTORY AUDIT**

- A statutory audit is carried out as a legal requirement for all limited liability companies.
- According to the company’s act each and every limited liability company shall appoint an auditor in each and every AGM.
- The auditor should lay before the members in the AGM the auditor’s report and the audited financial statements.

<b>Aspect</b>	<b>Statutory/public</b>	<b>Non-statutory/private</b>
Legality	It is a legal requirement	<b>It is voluntary</b>
Scope of work	The auditor uses his professional skill and judgement within the confines of the legal and professional framework, to determine the nature, timing and extend of work done.	The auditor’s scope of work is determined through an agreement between the client and the auditor
Level of assurance	Reasonable assurance is provided	Limited assurance is provided.
Audit risk	Its exceptionally lower	It is comparatively higher
Auditors liability	May extend to third parties	Doesn’t extend to third parties
Set of procedures	Extensive procedures	Limited procedures

**Advantages of statutory audit**

1. It enhances the credibility of the financial statements prepared by the management.
2. It protects the interests of the third parties who are involved the management of the business.
3. It acts a preventive and detective measure against frauds and errors.
4. The audited accounts can be used by the company for negotiating for loans from banking institutions.
5. The audited accounts can be used to determine the intrinsic value of the business in a business sale transaction.
6. The management of the company obtains valuable advices from the auditor on how to improve their operating systems and routines.

## **PRIVATE / VOLUNTARY AUDIT**

- A private audit is a voluntary audit that is conducted out of own volition and is not legal requirement.
- Such may be the case of audit of sole traders, partnerships, not for profit making entities and others.

### **Advantages/Pros of a private audit for a partnership**

1. It minimizes dispute between the partners.
2. It protects the interest of the dormant partners.
3. The partners benefit from valuable advices provided by the auditor.
4. The audited accounts can be used by the partners in negotiating for loans from financial institutions.
5. The audited accounts can be used to determine the intrinsic value of the business sale transaction.
6. More vigilance in accounting function.
7. It is a preventive and detective measure against frauds and errors.

### **Disadvantages/Cons of an external audit**

1. Potential leakage of confidential information to competitors as the auditor accesses all confidential records of the sole trader.
2. It may be expensive for a sole trader. 3. It may disrupt the normal operations.
4. The audit report may credibility due to absence of external scrutiny for private audits.
5. A qualified report will have a negative impact on the market value of the business for public audits.
6. It can only provide reasonable assurance at best as absolute assurance is not plausible.

### **Internal audit**

It is a continuous independent appraisal of the company's operations, systems and procedures by an internal auditor to determine their relevance, effectiveness and efficiency and provide feedback to the management

### **Differences between internal and external audits**

<b>Aspect</b>	<b>Internal audit</b>	<b>External audit</b>
Purpose	The purpose is to add value to company's operations	The purpose is to express opinion on the truthiness and fairness of the financial statements
Status of the auditor	Internal auditor is an employee of the company	External auditor is an independent contractor
Focus of the audit	The subject matter of the audit is activities and procedures	The subject matter of the audit is the financial statements
Scope of work	Scope of work is determined by the management	Scope of work is determined by
appointment	Internal auditor is appointed by the management	Auditor are appointed by the shareholders

Reporting	Internal auditor reports to the management	External auditor reports to the shareholders
Liability	Internal auditor is liable to the company under the terms of the employment	External auditor is legally responsible to the company under the terms of engagement and the liability may extend to third parties

### *Classification of Audit Based On Timing*

- The audit may choose to start the audit work earlier in the year or wait until year end to commence and complete the audit in one session. The timing of audit is influenced by a variety of factors which include:
  - a. The deadline fixed by the client
  - b. Size of the client’s business and volume of transactions
  - c. The extent to which the client can provide schedules and analysis
  - d. The extent to which the client has strong systems
  - e. The nature of the audit
  - f. The nature of the clients accounting systems i.e. whether manual or computerized
  - g. The quality of the client accounting systems.
  - h. Financial year ends of other audit clients

There are three alternative timings of the audit

1. Continuous audit
2. Interim audit
3. Complete/final audit

#### **1. Continuous audit**

- Involves examination of transactions as they take place. The auditor visits the client’s business to regular intervals throughout the financial year and performs examination of the client’s records.

#### **Conditions that are ideal for continuous audit**

- In audit of large organization with huge volume of transactions.
- When auditing organizations with strict reporting deadlines.
- Where the client systems are very weak.
- Where the auditor is under special audit assignment
- Where the auditors have the client with similar year ends.

#### **Work carried out during the continuous audit**

1. Obtaining an understanding of the client business
2. Ascertaining and recording systems.
3. Evaluating systems (compliance testing)
4. Limited analytical review procedures.
5. Limited substantive testing

#### **Advantages of continuous audit**

- 1) Its facilitates faster completion of the audit.
- 2) Errors and frauds are detected at an early stage.

- 3) It reduces audit risk.
- 4) It facilitates preparation of management letter at early stage
- 5) It act as a preventive and detective against frauds and errors.
- 6) It boosts the effectiveness of internal control systems
- 7) It causes the client staff to be more vigilant and up to date with their accounting records

#### **Disadvantages of continuous audit**

1. It may be expensive for the business.
2. Figures already audited may be altered by the client staff.
3. It disrupts the client work due to many number of visits.
4. The client staff may depend on the auditor to solve their accounting problems.
5. Questions raised by the auditor may remain outstanding for long and may never be addressed.

#### **Interim audit**

This the audit that is done in the year, that is, before the year ends on financial statements that do cover the whole year.

#### **Conditions that is ideal for interim audit**

1. For companies intending to pay interim dividends.
2. For companies that are required by the law to publish interim financial statements such banks and other financial institutions.
3. Where the company is operating in a volatile environment.
4. Where the client has a strict reporting deadline.

#### **Procedures/Work carried out during the interim audit (May 2021 q1a, August 2025 Q1)**

1. Ascertaining and evaluating the accounting and internal control systems.
2. Recording and evaluating the systems
3. Limited analytical review procedures.
  1. Limited substantive testing
  2. Vouching
  3. Notifying the weakness in the systems and providing recommendations for improvement.
  4. Planning the substantive procedures for the final audit
  5. Identifying potential problem that may affect the final audit

#### **Advantages of interim audit. May 2021 q1 b)**

1. It facilitates declaration of dividend.
2. It enables the auditor to prepare management letter at an early stage.
3. It facilitates faster completion of the final audit.
4. It enables the auditor to plan for the audit.
5. Errors and frauds are detected at an early stage.
6. It acts as a preventive and detective measure against frauds and errors.
7. It is less costly compared to continuous audit.
8. It is less disruptive than continuous audit.

### **Disadvantages of interim audit**

1. May be expensive for an average business
2. It may be disruptive.
3. Figures already audited may be altered by the client staff.
4. Errors and frauds are detected at much later stage compared to a continuous audit.
5. Client staff may depend on the auditor to solve their accounting problems.

### **Final / completed audit**

➤ This is the audit that is conducted at the end of the year on the financial statements ➤ It is conducted in two ways:

- ❖ In one session at the end of the year
- ❖ As a continuation and completion of the audit that was started at continuous or interim audit

### **Procedures/Work done during final audit (August 2025 Q1)**

1. Updating auditor's knowledge on the client business and systems.
2. Determining whether the internal control systems have changed during the interim up to the year end.
3. Carrying out compliance testing.
4. Final analytical review procedures.
5. Final substantive testing
6. Vouching transactions
7. Aggregating errors.
8. Assessing the appropriateness of accounting policies
9. Assessing the reasonableness of accounting estimates.
10. Assessing the validity of going concern assumption of the company
11. Reviewing subsequent events.
12. Writing and signing audit report.