

- COOPERATIVE AUDIT AND CONTROL
material for management training in co-operatives

TRAINER'S MANUAL

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MATCOM
Material and techniques for cooperatives management
training

The MATCOM Project was launched in 1978 by the International Labour Office, with the financial support of Sweden. In its third phase (1984-1986) MATCOM is financed by Denmark, Finland and Norway.

In collaboration with cooperative organizations and training institutes in all regions of the world, MATCOM designs and produces material for the training of managers of cooperatives and assists in the preparation of adapted versions for use in various countries. MATCOM also provides support for improving the methodology of cooperative training and for the training of trainers.

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Preface

This training package is one of many developed and produced by the ILO-MATCOM Project to assist people who plan or carry out training - especially management training - for the staff of co-operatives in developing countries.

The training provided under this package is based on a thorough analysis of the tasks and functions involved in audit and control in the context of co-operative organisation and management, as well as the systems and procedures involved in co-operative book-keeping and accounting.

The training package is intended for training auditors of co-operative societies, whether they are employed by and work within the societies themselves (internal auditors), or by organisations or institutions which provide audit services to co-operative societies (external auditors) - such as co-operative federations, government departments responsible for co-operative development or agencies specialising in the auditing of co-operatives. It is also intended for training co-operative inspectors and supervisors whose duties entail audit and control.

It is hoped that the training provided in this, as in the other MATCOM training packages, will help increase efficiency in the performance of co-operatives in the developing countries.

For more information about other material in the series, please write to:

The ILO-MATCOM Project
c/o CO-OP Branch
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CH-1211 Geneva 22
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THE TRAINING PROGRAMME1. Target Group

This programme on "Co-operative Audit and Control" is designed to assist the training of co-operative auditors (internal and external) and inspectors. It is expected that the trainees will have accounting knowledge but may not have acquired an accounting qualification and will have some experience of auditing.

2. Aim

The aim of this training programme is to enable trainees to competently implement audit programmes and review control systems in co-operatives.

In particular the programme will enable trainees to:

- apply the theory and practice of auditing and to be able to relate this to co-operative activities;
- check the accuracy of accounts and the underlying book-keeping entries;
- document and evaluate internal control systems;
- ensure that generally accepted accounting standards have been adhered to;
- check and determine whether the operations recorded have been undertaken in accordance with the policies of the co-operative organisation;
- provide necessary advice to the co-operative organisations on accounting, financial management, policy control and related matters, during the conduct of an audit and through reports;
- recognise the fact that a co-operative auditor is required to do more than simply verify the truth or otherwise of the accounts and that the auditor must be prepared and be able to use his unique position as an independent observer to make a positive contribution to

the managerial efficiency of co-operatives so that they can benefit the members.

3. Objective :

The training course described in this manual is made up of 11 topics, each of which is divided into a number of sessions; there are 35 sessions altogether (see page X) Briefly summarised, their objectives are to enable trainees to -

- describe the functions, objectives and scope of auditors and to explain the differences and similarities between internal and external auditing;
- distinguish between errors, fraud and waste, evaluate the significance of each in relation to the accounts being audited, and determine what action should be taken when they come across cases of errors, fraud and waste;
- explain the need for different types of internal control systems in a co-operative, their costs and benefits and the need to evaluate these control systems as part of the audit process;
- apply adequate methods for the verification of fixed assets, stock, other current assets, and liabilities;
- distinguish between different types of audit tests, use adequate methods of selecting samples for testing, and perform effectively analytical reviews and vouching;
- explain the advantage of using "audit programmes" and maintaining working papers and the importance of careful planning and timing of the audit work;
- explain the purpose of an audit review before the report is prepared, and prepare audit reports of different types, including "management report";
- apply an adequate approach when auditing co-operatives which make use of computers;

- recognise the special requirements of an investigation;
- expand the statutory auditing into "management auditing" for the benefit of the co-operative.

4. Timing, Structure and Use of the Material

The manual is divided into 11 topics. Each topic consists of several sessions. The following material is provided for each session:

- a session guide for the trainer (yellow pages), giving the objective of the session, an estimate of the time needed and a comprehensive "plan" for the session, including instructions on how to conduct the session;
- a handout (white pages) of all case studies, role play briefs, etc. to be reproduced for distribution to the trainees.

It is expected that the complete programme of 35 learning sessions will take between 3 and 4 weeks. Anticipated session lengths vary and will depend on the ability and experience of the trainees. A single course is anticipated but as there is division between topics the material might be presented in sections over a period of time. In either case it is essential that a sufficiently flexible timetable should be prepared.

Guest speakers can be used to supplement the programme. They should help relate theory to practice and will maintain the trainees' level of interest.

5. Training Approach

This programme is based on the assumption that training is expensive and that funds for training are scarce. Training is an investment, and unless the training yields results which are greater than that investment, it would have been wiser to use the money for some other purpose.

On their return to work from the training programme, participants should be able to show concrete results. In order to prepare them to achieve this, the sessions include little or no theory; it is almost entirely participative, with the minimum of lecturing and a maximum of shared experience and learning.

Throughout the programme, problems facing co-operative auditors have been translated into realistic case studies, role plays and other problem-solving exercises. Trainees working both in groups and individually will learn by solving these problems, with the necessary assistance and guidance of the instructor, who must act more as a "facilitator" of learning than as a lecturer.

Auditing is not an exact science and every audit creates the possibility of a different approach depending on the local situation. The material is organised to encourage trainees to contribute as much as possible from their own thoughts and experience. Every trainee should be treated as a source of ideas and the material is designed to elicit these -ideas.

The last session, on "Action Commitment", is designed to ensure the "bridge" between that course and the working world is as easily crossed as possible. Working with each other and with you, each participant should come up with a very specific plan of what he or she proposes to do on return home. You should make every effort to ascertain whether or not they implement their plans and to support them in their efforts. If they fail it is the course that is at fault; and if they succeed, you - the instructor - can take a great deal of the credit.

6. Preparing the Training Material

Handouts constitute an important part of the training material used in the programme. They can be reproduced from the original handouts supplied in this ringbinder, after the necessary adaptation has been made. Reproduction may

be done using whatever method is available: stencil, off-set printing, photocopy, or other.

The only item of training equipment which is absolutely essential is the chalkboard.

Some suggestions for visual aids are given in the session guides. If flip charts or overhead projectors are available, you should prepare these aids in advance. If they are not available, you can still use the chalkboard.

The Pre-course Questionnaire (See Session 1) should be sent to the participants in advance. They should be asked to complete it and hand it in the beginning of the programme.

7. Preparing Yourself

Some trainers may feel that material of this sort means that they need only spend a few minutes preparing for each session. This is not the case.

You should go through the following steps before conducting any course based wholly or in part on this material:

- a. Read it carefully; be sure you understand the content and that you can envisage what is intended to happen in the classroom.
- b. Work through all the calculations; be sure that you understand them completely. Try to predict the errors that trainees are likely to make, and the different answers which may not be wrong, but which will be worth following up.
- c. Work through the case-studies yourself and try to predict all the possible analyses and answers which trainees may come up with.
- d. Look up and write down on the material itself, as many local examples as you can to illustrate the points that are raised.

VIII

- e. Plan the whole session very carefully; try to predict approximately how many minutes each section of the session is likely to take, and make the appropriate modifications to fit into the time you have available. Do not take the suggested time at the beginning of the session too seriously.

8. Conducting the Programme

While using the material, you should try to observe the following guidelines:

- a. Arrange the seating so that every trainee can see the faces of as many as possible of the others; do not put them in rows so that the only face they can see is your own.
- b. Be sure that the session is clearly structured in the trainees' minds. Outline the structure at the beginning, follow it or say that you are diverging from it, and summarise what has happened at the end.
- c. Bear all the learning points in mind, and do not forget the job-oriented objectives of the session.
- d. Be flexible; do not follow the material slavishly and be prepared to change the approach, depending on what trainees themselves suggest.
- e. Avoid, whenever possible, telling the trainees anything; in a successful session all the points will have been elicited from them by skillful questioning.
- f. If you fail to draw a particular answer from the trainees, it is your fault, not theirs. Persist, asking the same question in different ways, hinting at the response you want. Only make the point yourself as a last resort.
- g. Use silence as a weapon; if nobody answers a question, be prepared to wait for 20 or 30 seconds in order to embarrass somebody into making an attempt.
- h. Avoid talking yourself. Trainees' discussion and sug-

gestions should occupy around three-quarters of the total time. Ask, listen and guide rather than talk. (The most you yourself talk, the more you are revealing your own insecurity or ignorance of the subject, in that you are not willing to risk questions or comments with which you cannot deal).

- i. Never ridicule a trainee's answer or suggestion; there is bound to be some merit in it somewhere, and the very fact that he or she has put forward a suggestion is commendable.
 - j. If you cannot answer a trainee's question, or comment on a suggestion, (or even if you can) ask another trainee to answer or make a comment. You are the facilitator, not the source of knowledge.
 - k. Write trainees' own words on the chalkboard whenever possible; do not follow the word in the material, even if they are more precise.
 - l. Be prepared to act as "Devil's Advocate", there are no right or wrong answers to all audit questions, and trainees must see and understand both sides of an issue.
 - m. If trainees appear to be following a quite different track from that suggested in the material do not dismiss this out of hand; it may be as useful or more so.
 - n. Call on the silent and, if necessary, silence those who talk too much.
 - o. Be sure that everybody understands what is going on; do not allow discussion to be taken over by a few who understand.
9. After the Course

Be sure to contact all participants, in person or at least by letter about six months after the end of the course or find out how they have managed to apply what they have learned and how well they are implementing their action commitments: If they have failed, it is not

they who were at fault, but the course. Either the training was ineffective, the participants were poorly selected or you failed to recognise problems which might prevent them from applying what they learned.

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PRE-COURSE QUESTIONNAIRE

In order to assist the trainer with his preparations for the course on Co-operative Audit and Control, kindly complete and return the following questionnaire.

Name:.....

Job Title:.....

Age:.....

Brief description of your duties:.....

.....

.....

Brief description of your accounting experience:.....

.....

.....

Brief description of your auditing experience(if any):.....

.....

.....

As a result of attending the course on Co-operative Audit and Control, I hope that I shall be able to:

.....

.....

.....

cooperative audit

Session 1.1 Introduction

Session 1.2 Definition and Objectives

Session 1.3 Scope

Session 1.4 Qualities of an Auditor

SESSION 1.1

INTRODUCTION

Objective: To demonstrate the importance of auditing in co-operatives, to explain the objectives of the programme, to introduce instructors and trainees to one another and to ensure that all administrative details are dealt with.

Time : 1 1/2 to 2 hours.

Material : Timetable.
List of course participants.
Completed pre-course questionnaire.

Session Guide :

- 1) The opening statements should be kept brief and very much to the point. The following points should be stressed in the opening remarks.
 - All organisations need to make the best use of available resources. This is especially the case with co-operatives where the profit motive is not usually the prime aim of the organisation, and where financial resources are often limited. Co-operative auditors must see themselves as one of the resources which can positively contribute to the success of the organisation.
 - The material is designed to allow the trainees to contribute as much as possible from their own thoughts and experiences.
 - An explanation of what is expected from the course participants especially with regard to applying the knowledge and skills gained from the course in their work.
 - Auditing is not an exact science and that every audit

creates the possibility of a different approach.

- 2) Ask each trainee to introduce him or herself and to summarise his or her previous training and experience. Identify any special experience and emphasise the strengths of the group as a whole.
- 3) Ensure that all administrative issues such as accommodation payment of expenses, travel arrangements, room for private study etc. are adequately dealt with. Nothing interrupts a course more than the trainees worrying about administrative matters which could have been dealt with at an earlier stage.
- 4) Ensure that trainees know, at all times, where to contact you or other responsible persons should they have any urgent problems. You do not want people disappearing from the course without at least discussing the matter first, as this has obvious implications on group work.
- 5) Go briefly through the timetable. Point out that there is flexibility to allow more time to be spent on areas of difficulty. Stress that the trainees will learn more by participating than simply by listening.
- 6) In order to stress the objectives of the course, ask trainees if they have experienced examples where lack of audit has adversely affected a co-operative organisation or where an audit has had no beneficial effect. Questions such as the following should bring out some examples:
 - Have any of the trainees detected areas of weakness where resources have not been used to best effect, but which have not been reported by the auditors as they did not feel it was their job to interfere with the management of the society?
 - Do Co-operative members have any interest in the audit report?

- Do any of the staff of co-operatives resent the appearance of the auditors or see the auditors' task as unnecessary?

There will always be some examples of the above due to the relationship between benefit and cost. An audit which highlights each and every error will undoubtedly cost more than the benefit gained by the co-operative. Against this must be weighed the cost of a report which is of no benefit to the organisation.

The auditor must aim for a balance between the benefits gained and the cost incurred. He must also make use of his unique position as an independent observer to make a positive contribution to the organisation.

- 7) If you have decided to ask the trainees to undertake a short test in accounting knowledge, this should be done now.

SESSION 1.2

DEFINITION AND OBJECTIVES OF AUDIT

Objective : To enable trainees to clearly describe the function of auditing and to recognise the objectives of auditing co-operative organisations.

Time : Two to three hours.

Material : Tape dialogue "Timebound Audit Department". (To be recorded in advance of session, if possible)

Session Guide :

1) Ask trainees to give one statement which they think should be included in a definition of auditing. You are likely to get responses such as the following:

- Checking the books.
- Making-sure no money is missing.
- Verifying the assets.
- Making sure the managers are doing their work properly.

Each of the above is partly correct but you are required to draw out more exact responses which give greater depth to the definition you are working towards. You should ask questions which are weighted to draw out responses:

- Why is an audit necessary?

We will develop this and most of the other points at a later stage, but the basic reason is almost always because the law says so. It is usually a statutory requirement for co-operatives to be audited on a regular basis.

- Why does the law insist on an audit?

There is an need to ensure that the users of the accounts can believe what the managers are reporting to them.

- Can someone within or closely-related to the co-operative be its auditor?

Usually not - it is generally accepted that the auditor should not be closely involved with the society or its staff. The auditor should be independent of the society.

- Who decides who is to carry out the audit?

All auditors are appointed by someone to carry out the duties. Often the Registrar of Co-operatives, the Co-operative Commissioner or the Director of Co-operatives makes the appointment but depending on local statutes, the members may appoint the auditor at a General Meeting.

- What does an auditor look at when carrying out his work?

He examines the books, records and financial statements of the co-operative.

- What does the auditor do after he has examined the books, records and financial statements?

He writes a report, expressing an opinion on the truth and fairness of the financial statements of the organisation.

- How should an auditor base the level and quality of his work?

International audit firms, together with their governing bodies, have drawn up a code of minimum standards by which they must operate. Failure to do so can leave these firms open to charges of negligence and serious financial penalties. In many developing countries the high standards have not yet been achieved but, depending on the business development of the country you

work in, there will be a level of accepted standards by which the local auditor should operate.

- 2) Having helped trainees to elicit the above responses, you should now ask them to develop their own definitions of auditing. An example is given below but do not adhere to it too strictly. Allow trainees to make their own definition as long as it contains the points underlined. Be prepared to spend some time explaining these expressions to the trainees.

"An independent examination of, and Expression of opinion on, the financial statements of a co-operative organisation by an appointed auditor, who carried out his duties according to accepted audit standards and in compliance with a statutory obligation".

- 3) Play the dialogue, or if a tape recorder is not available select two trainees to act the roles of Mr. Ahmed and the interviewer. Stop the dialogue at each bleep and ask trainees to comment on Mr. Ahmed's policies. Do these seem to be relevant to the description of auditing given before? Can you suggest changes that might be needed?

Answers should include the following points:

- a) Mr. Ahmed denied that he had any responsibility regarding the bankruptcy as he had performed his job as laid down by law. The auditor should assume a responsibility beyond any legal requirement as various groups of people are likely to rely on his report.

Ask who might use audited accounts? Answers should include:

- The members of the society.
- A co-operative union or wholesale society.
- Employees of the society.

- Lending agencies and bankers.
- The Government.
- The media.

The majority of the audit was performed by a trainee who did not seem to have been adequately supervised. For the auditors' report to be credible the person performing the audit should be sufficiently qualified even if this is only through experience.

Mr. Salam is the nephew of the chairman of "Bye-more". It is possible that he might have been influenced by his uncle and therefore cannot be considered independent.

For accounts to be useful they must be timely. A gap of one year can make the accounts irrelevant.

- b) There was no audit programme to adhere to, so there can be no assurance that minimum standards were met. All audits are different but they all have similarities. A flexible audit programme should be used to ensure some form of consistency is achieved.

It appears that the only evidence of the audit work performed was a memo to Mr. Ahmed. It is important that proper working papers - called "audit evidence" - can be referred to at a later date and will provide a basis for future work.

It seems that Mr. Salam checked all the records but didn't compare the records to what was actually happening. Discreet questioning of the staff might easily have revealed the other cash book. However on this point it is important to remember that modern audit is not expected to find every error - only those which affect the truth or fairness of the accounts in a material manner.

- c) The auditor should be aware of significant changes in major items making up the accounts. In this example,

the tripling in the value of stock should have rung some alarm bells. The valve radios might have been truthfully valued at cost, but if it is not possible to sell them then the "fair" value might be nil, and a write-off of these stocks might severely affect profits.

Comparison is always an important part of auditing and if one shop is making 15% gross profit why should another only make 5%? Again this does not affect the credibility truth of the accounts but management should be aware of the situation. If the shops are basically selling the same range of goods to similar types of members, distance between the shops is irrelevant.

- d) If the stocks are not worth the figure given in the accounts, the bank would have every right to be annoyed. This brings us back to the first point whereby auditors should recognise that many groups may use the accounts and rely on the audit report for assurance.

It would appear that the accounts were true (depending on the records only) but probably were not fair.

Mr. Ahmed said he could have told the bank that "Bye-more" was having problems. However an auditors' information should be considered as confidential and should only be released directly if the management of the society has given him permission to be used as a reference.

The modern auditor is expected to do more than follow the letter of the law and co-operative auditors should keep up with developments in the profession.

- e) It is not an auditor's job to interfere but if he is aware of problems or weakness he should point these out to the management of the society and, where pos-

sible, propose solutions to these problems. This year's problems could be next year's bankruptcy.

Co-operative audit departments are often unable to match the abilities of commercial firms, through lack of resources or other constraints. However this should not result in a deliberate lowering of standards. In many respects co-operative auditing is similar to that of private businesses and although the section of law appropriate to the auditing of each may differ, often the objective is the same.

- 4) From the definition of auditing established at the beginning of the session and from the comments on "Byemore Co-operative" it is now possible to formulate objectives of co-operative auditing. This is usually given in the form of a principal objective with a number of subsidiary objectives.

Ask the trainees to provide the subsidiary objectives first; these should include:

- To give credibility to financial statements (which will be used by a variety of people and organisations).
- To conform with legal and organisational requirements.
- To detect material errors.
- To detect material frauds.
- To highlight system weaknesses.
- To highlight personnel weaknesses.
- To provide advice and assistance.
- To comply with minimum accepted audit standards.
- To ensure that co-operative principles have been adhered to.

The principal objective of co-operative auditing, which may vary slightly with the requirements of individual countries can be summed up as follows.

"To state that the audited accounts give a true and fair view of the co-operatives' financial situation in a manner that is both reliable and credible".

- 5) The achievement of these objectives has to be confirmed in a statement by the auditor, which should appear with the accounts. This "audit report" is often no longer than two or three sentences, but these sentences are very important.

- 6) If sufficient time remains, play the dialogue tape again and ask the trainees to point out where the audit objectives are not being met by Mr. Ahmed's department.

TIMEBOUND AUDIT DEPARTMENT

Mr. Ahmed, the chief auditor of the Co-operative Department is being interviewed by a journalist after a consumer co-operative has been declared bankrupt and has ceased trading. All members have lost not only the services provided by the store but also their investment in it.

Interviewer: It is good of you to agree to give me some of your valuable time, Mr. Ahmed. I wonder if we could start with the role of your department in the matter of the closure of the Bymore Co-operative.

Mr. Ahmed: First of all let me state that we had no part at all in this sad event and personally I feel very sorry for the members who have lost their money. Our task, as laid down by law, is to audit the accounts and that is exactly what we did. Why, I signed the report myself on 19 July this year.

Interviewer: Indeed you did. I have the accounts here and your report says "We have audited the accounts for the year ending 31st July 1991 and have found them to be correct." Can you tell me who actually did the audit and why were the accounts not finalised until almost a year afterwards?

Mr. Ahmed: Although I signed the report, most of the work was undertaken by Mr. Salam, who is a trainee in the Department - a very able young boy who has a good future ahead of him. He's very thorough and I'm confident he checked every transaction. He was well-suited for the job as his uncle was the chairman of the society, so you

see, he knew what was going on. The accounts did take a bit of time - we were very busy - understaffed I'm afraid.

BLEEP A

Interviewer : Can you tell me what sort of test were performed by Mr Salam? Did he work to a programme?

Mr. Ahmed : We don't use audit programmes. I find they're a waste of paper as every audit is different. I'm sure he did all the usual tests - you know, vouching the payments, checking salaries, counting the stock - I told you he was very thorough. He gave me a memo at the end of his work saying he had performed all tests satisfactorily. I remember the only thing wrong was that the salaries clerk had forgotten to deduct tax one month. He made sure they put that right!

Interviewer : I believe that one of the problems was that the cashier had "borrowed" about \$10,000. Why didn't your audit pick that up?

Mr. Ahmed : He was a bit too clever for us there- he had another cash book. The one we tested was fine. After the closure, we came to realise what he was doing. The store assistant told us there was another book! Anyway it wasn't the missing \$10,000 that caused the problems, it was mainly the high level of stock.

BLEEP B

Interviewer : The level of the stock had tripled in the last year. Didn't that raise your suspicions that something was wrong?

Mr. Ahmed : I was surprised but not worried. I knew that Salam had checked the stock and it was all there. It's not our job to say whether or not the level is too high. Salam did say something about 5,000 valve radios having been there for a few years but management know best what they need.

Interviewer : In 1991 the Clean Consumer Shop made a gross profit of 15% on sales, but the Bymore Shop made only 5%. What do you think caused this?

Mr. Ahmed : Well, Bymore's purchase clerk was getting on in years - couldn't get round all the suppliers, so he wasn't getting very competitive prices anymore. Anyway you can't compare the two shops - they're 500 kilometres apart.

BLEEP C

Interviewer : I believe the bank lent the society \$100,000 on the basis of last year's accounts. They say that because the accounts were audited they thought there weren't any problems.

Mr. Ahmed : What are they worried about? They secured the loan on the society's stocks - they'll get most of it back. It's the members I feel sorry for. The bank should have done a bit more work for themselves before they approved the loan. I could have told them the co-operative was in trouble if they had bothered to ask.

Interviewer : I believe the commercial audit firms say in their reports that the accounts show a "true and fair view". Do you think the Bymore accounts were "true and fair"?

Mr. Ahmed : Of course they were true - I said so in my report. I don't know what you mean by fair - who's to say what's fair in this life? It's certainly not fair that the members lost their money but they have the management and bad luck to blame for that. The law doesn't say anything about "true and fair" and the Co-operative Act of this country is what I really care about.

BLEEP D

Interviewer : I believe it's common for commercial audit firms, after the audit is finished, to issue a letter to a company's management pointing out any areas of weakness that they found and giving recommendations for improvements. Do you do this in your Department?

Mr. Ahmed : Certainly not! It's not my job to interfere with the management of societies - what do I know about the details of running a co-operative? I leave that to the experts, as I expect them to leave auditing to me. If they've broken the law or failed to abide by society bye-laws, I'll soon let them know but otherwise I don't interfere.

Interviewer : Mr. Ahmed, thank you for your time. I'm sure my readers will be very interested in what you have said.

Mr. Ahmed : Thank you very much, but I'd just like to make one more point before we finish. You can't compare us with commercial audit firms. We're dealing with co-operatives, not private businesses. We can't be expected to match their standards - we haven't got their resources or their quality of staff - more to the point, we don't even operate under the same law.

SESSION 1.3

SCOPE OF CO-OPERATIVE AUDIT

Objective : To enable trainees to recognise the scope of auditing activities applicable to co-operative audits.

Time : 1 1/2 to 2 hours.

Material : Extract from ILO Recommendation No. 127.

Session Guide :

- 1) Before the session begins, write on a flip chart or chalkboard the objectives of auditing as identified in session 1.2.

- 2) Ask the trainees if anyone can give a brief synopsis of ILO Recommendation 127 regarding the role of co-operatives in the economic and social development of developing countries.

Hopefully as members of the co-operative movement, the trainees should be aware of this recommendation, but if no-one is able to give a satisfactory description it would be worth spending a few minutes explaining the main points of the recommendation yourself as follows:

"The establishment and growth of co-operatives should be regarded as one of the important instruments for economic, social and cultural development as well as human advancement in developing countries."

"Governments of developing countries should formulate and carry out a policy under which co-operatives receive aid and encouragement, of an economic, financial, technical, legislative or

other character, without effect on their independence."

"Methods of policy implementation should include appropriate legislation, education and training, aid, supervision and collaboration."

Point out that auditors should be involved in this policy in two aspects:

- a) Ensuring compliance with legislation.
- b) Supervision.

Ask the students what type of co-operatives Recommendation 127 applies to. The answer should be all types of co-operative organisations, from pre co-operative groupings to national unions. This is identified as the scope of the Recommendation - the type of organisation to which the Recommendation applies.

Give out a copy of the extract of Recommendation 127 and ask the trainees to compare their suggestions with those included in the scope of the Recommendation. It is possible that they will have thought of more than what is stated in the Recommendation.

- 3) Once this has been established, ask the group what they think the scope of co-operative auditing is - to what type of co-operative organisations does it apply?

As before the answer should be: all types. It is unlikely that there is any grouping that does not have some form of financial transaction which should be audited.

n.b. It is possible that a specific legal statute may exempt certain types of co-operatives from audit. Check if this is the case in the country where you are holding the training course. If this is the case, give an explanation of the reasons.

- 4) Ask the trainees to list of types of co-operative existing in the country you are working in. Write three on

the chalkboard. These should be as varied as possible, but should all comprise the types of co-operative which the trainees will eventually be auditing.

For example you might choose:

- a) A national wholesale co-operative.
- b) A fisheries co-operative.
- c) A womens' thrift and credit co-operative.

Briefly remind the trainees of the objectives of co-operative auditing (as stated on the flip chart or chalkboard).

Divide the trainees into three groups and ask each group to write down the activities of each type of co-operative chosen. Ask what the auditor should look at and what should they verify? What is the scope of this specific audit?

After 10 minutes or so, ask the groups to read out their answers for society (a).

It is likely that they will centre on checking the financial books and records of the co-operative:

- Vouching the cash book to receipts and payments.
- Verifying debtor balances, bank accounts, cash etc..
- Verifying liabilities.
- Checking salaries.

Hopefully the answers given for each society will be similar, for although they may be different types of co-operatives they should all conform to co-operative principles. Book-keeping for any type of organisation operates on the same bases.

Show the trainees how an item which may have only been stated for one society can be applied to the others as well, e.g. verifying loans to members is obvious for a thrift and credit society but is just as important for a

wholesale organisation or for a fisheries co-operative.

Of course there will be differences. The wholesale co-operative is likely to use computers but a small thrift and credit co-operative is not likely to. The fisheries co-operative may allow credit sales while the wholesale co-operative may operate on a "cash only" policy.

The point to make is that the scope of individual audits will conform to similar patterns and in order to achieve his objectives, the auditor should direct his attention to the following general areas which include items outside the financial records of the organization:

- Examination and testing of the system of book-keeping and other financial controls.
- Comparison of financial statements with the books and records to ensure that they are in agreement.
- Verification of assets.
- Verification of liabilities.
- Comparison with previous years and similar organisations to ensure that there are no obvious differences for which the auditor is not aware of.
- Examination of non-financial records, such as the minute book and members' register.
- Discussions with management regarding the activities of the co-operative.
- Examination to ensure that statutory requirements have been met.
- Obtaining written confirmation from management regarding specific items.

For each of the above ask the trainees to point out in the examples they gave for the three societies, a test which relates to the areas mentioned. If no example was given at the time ask them to give one now.

- 5) For some trainees this description of the scope of audit may be much wider than they had anticipated.

Discussion with management on the effects of inflation is very different from - and may be more important than - adding up a receipt book. Reviewing 'committee decisions recorded in the minute book and following up the results of these decisions may be more important than adding up the petty cash.

Ask the trainees for examples of the above and for similar situations where routine checking is not sufficient.

- They should be able to state that rampant inflation, can rapidly erode the financial base of an organisation and affect the "fairness" of the financial statements.
- If management has made a poor decision about a range of stocks which are not selling, this could have a great deal more significance for the auditor than a small petty cash balance. Establishing the "fair" value of the stocks could be of crucial importance in the audit.

- 6) For these reasons you should return to the primary objective and emphasise the need for "Truth and Fairness". Checking that the accounts are true is a relatively easy task established by routine testing. The requirement for "fairness" expands the auditors' responsibility and work.
- 7) Over the years the whole approach to auditing has changed. The old concepts of routine checking and vouching have diminished in importance and new techniques concentrating on the control systems of the co-operative have been developed.

This is illustrated by the saying that an auditor is no longer a "bloodhound" but a "watchdog".

The user of audited co-operative accounts should be confident that the figures given have been fairly compiled, using the combined principles of accounting, auditing and co-operative policy.

INTERNATIONAL LABOUR CONFERENCE

Recommendation 127

**RECOMMENDATION CONCERNING THE ROLE OF CO-OPERATIVES
IN THE ECONOMIC AND SOCIAL DEVELOPMENT OF DEVELOPING
COUNTRIES**

The General Conference of the International Labour Organisation,
Having been convened at Geneva by the Governing Body of the
International Labour Office, and having met in its Fiftieth Session
on 1 June 1966, and

Having decided upon the adoption of certain proposals with regard
to the role of co-operatives in the economic and social development
of developing countries, which is the fourth item on the agenda of
the session, and

Having determined that these proposals shall take the form of a
Recommendation,

adopts this twenty-first day of June of the year one thousand nine
hundred and sixty-six the following Recommendation, which may be
cited as the Co-operatives (Developing Countries) Recommendation, 1966:

I. SCOPE

1. This Recommendation applies to all categories of co-operatives, including consumer co-operatives, land improvement co-operatives, agricultural productive and processing co-operatives, rural supply co-operatives, agricultural marketing co-operatives, fishery co-operatives, service co-operatives, handicrafts co-operatives, workers' productive co-operatives, labour contracting co-operatives, co-operative thrift and credit societies and banks, housing co-operatives, transport co-operatives, insurance co-operatives and health co-operatives.

SESSION 1.4

QUALITIES OF AN AUDITOR

Objective: To enable trainees to recognise the qualities of a good auditor.

Time: 1 to 1/2 hours.

Material: Sketch "The Co-operative Auditor?"

Session Guide:

- 1) Refer again to the definition and primary objective of co-operative auditing established in session 1.2, ensuring that the trainees have sufficiently understood them.
- 2) Explain that if a member of a co-operative had no confidence in the auditor he probably would not be prepared to believe that the audit had been properly carried out and therefore would have no faith in the audit report.

Ask the trainees if they can give examples of why a member of the co-operative, or any other user of accounts, might not have confidence in the auditor?

Answers are likely to fall into two groups and you should write these on the chalkboard as the trainees identify the reasons. As before you may have to ask some leading questions before all the examples below are raised. Hopefully the trainees will be able to think of some more.

- a) Because the member knows, has heard or suspects something about an individual auditor who was involved in the society's audit:
 - The auditor has no idea about how a co-operative functions.
 - He never passed an examination in his life.

- He is related to the manager or a board member and wouldn't report anything wrong even if he found one.
- He never bothered talking to the members to find out what they think is going on.
- He is suspected of taking a bribe.
- He is rumoured to have spent time in prison.

b) Because the member knows, has heard or suspects something about the Audit Department which has prejudiced his view of all the people working there:

- The only qualification required for working in the audit department is to be related to the Director.
- They issue reports all the time but nobody pays any attention to them as the accounts are often proved to be wrong afterwards.
- They weren't able to pick up that massive fraud in XYZ Co-operative which had been going on for 3 years.
- Sometimes they do a good job, sometimes they do a bad job but you can never tell which one it's going to be.
- They're inconsistent.
- The auditors only spend a few days a year on the audit. How can they know anything about the co-operative?

3) Each of the above examples identify a lack of an essential quality that good auditors should possess. These can be split into three types:

- Independence: An auditor cannot give an unbiased opinion unless he is independent of all the parties involved. He must be able to design his own work programme, have free access to all records, and be free from outside pressures intended to influence his work and report.
- Competence: An auditor should be adequately quali-

fied or experienced in order to understand the co-operative activity he is dealing with.

- Integrity: An auditor must be honest, discreet and tactful.

Return to the examples on the chalkboard and ask the trainees which quality is lacking in each case. Most of them will be fairly obvious (e.g. The person who is suspected of taking a bribe lacks integrity) but some will require longer discussion, for example, do inconsistent results stem from a lack of competence or from poor attitude, which might be considered as a matter of integrity?

- 4) Hand out the sketch of "The Co-operative Auditor". Ask the trainees to divide into groups and undertake the assignment set.

This is, of course, meant as a bit of fun but should also allow the trainees to distinguish between good and bad auditor qualities.

Discuss each characteristic in turn and, in addition to deciding whether the quality signified is desirable or not, establish which of the general headings it falls under.

- a. "High forehead for intellectual skills" -(Competence)

- The high forehead is not required, but an auditor must be reasonably knowledgeable in his field. He must have a good practical understanding of accounting and co-operative principles, must be numerate and must have sufficient literate skills to be able to communicate his findings in an effective manner.

- b. "Large ears for listening with" - (Competence)

- He doesn't need big ears, but the auditor must

have an inquisitive mind and must be aware of what is happening around him. It is common for disgruntled employees to hint at problem areas or even of frauds that are being committed by others. If the auditor does not listen to what people are trying to tell him, he will never be able to do the job well.

- c. "Big nose for sniffing out problems" - (Competence)
 - As above, the physical characteristic is not required but an inquisitive mind is. A small error may be a sign of a much larger one and a good auditor will follow matters through until he is satisfied with the results.

- d. "Thick glasses for reading the books" - (Competence)
 - Spectacles are not required but comprehension is. The auditor must be able to do more than read the figures, he must understand them and be able to explain what they mean.

- e. "Zip on mouth" - (Integrity)
 - The auditor is exposed to confidential information about the co-operative. He must not discuss the affairs of the co-operative with anyone who is not involved with the audit. Just as it is wrong for a doctor to gossip about his patients, or a lawyer about his clients, it is very wrong for an auditor to gossip about the financial health of a client.

- f. "Large throat for swallowing managers' excuses"
 - Definitely not required. If management puts forward excuses it is the auditor's job to test the validity of the reasons given and make suitable comments. He must not blindly accept whatever he is told by management.

- g. "Calculator" (Competence)
 - There are very few auditors who would operate

without a calculator or in some countries, an abacus) these days. It is not essential but is one of the "tools of the trade" and it does not create a good impression if you have to borrow a calculator as soon as you start work. The exceptions to this are those lucky people who can do all necessary calculations in their head. This of course creates a better impression than using a calculator.

- h. "Red and green pens" - (Competence)
 - As with the calculator this characteristic is an outward indication of being able to do the job properly.
- i. "Shirt and tie" - (Competence/Integrity/Image?)
 - Being neatly dressed does not make a good auditor, but it does reflect a professional image and is expected by those being audited. A scruffy auditor can overcome any initial reaction by proving he is good at his job, but this may take some time. Why create a poor impression in the first place when a little effort could avoid the problem.
- j. "Large right hand for shaking hands with co-operative members" (Independence)
 - A co-operative auditor must remember who he really is performing the audit for - the members and not the management. The members own the co-operative and it should be run for their benefit. The auditor should meet as many members as possible (without wasting time) to find out how they feel about the way their society is being run. He must show he is independent of the management and not above talking with members.
- k. "Stick for beating wrongdoers"
 - Not required. The law will lay down the appropria-

to penalties. The auditor reports, he does not take punitive action.

1. "Diploma to prove qualification" - ((Competence)
 - Very useful, but remember qualification on paper is not everything; and experience and common sense count for a lot as well.
- m. "Executive briefcase for show" - (Competence)
 - Not required for show, but because he might carry confidential information and because of the value of his working papers, the auditor must have somewhere safe and secure to store these papers. Of course this doesn't have to be an executive briefcase, a lockable filing cabinet would do but these are difficult to carry around when out on audit.
- n. "Big boots for stamping on unruly managers"
 - Not required. As with the stick mentioned above, the law will stipulate the appropriate action and penalties. However, these boots could be seen as a sign of independence. The auditor is able to stand on his own two feet without being swayed by outside pressures.

- 5) It can be seen that competence is illustrated more easily than independence or integrity. The co-operative auditor can demonstrate that he has the appropriate qualifications, experience and ability. A trainee auditor can learn and acquire these attributes.

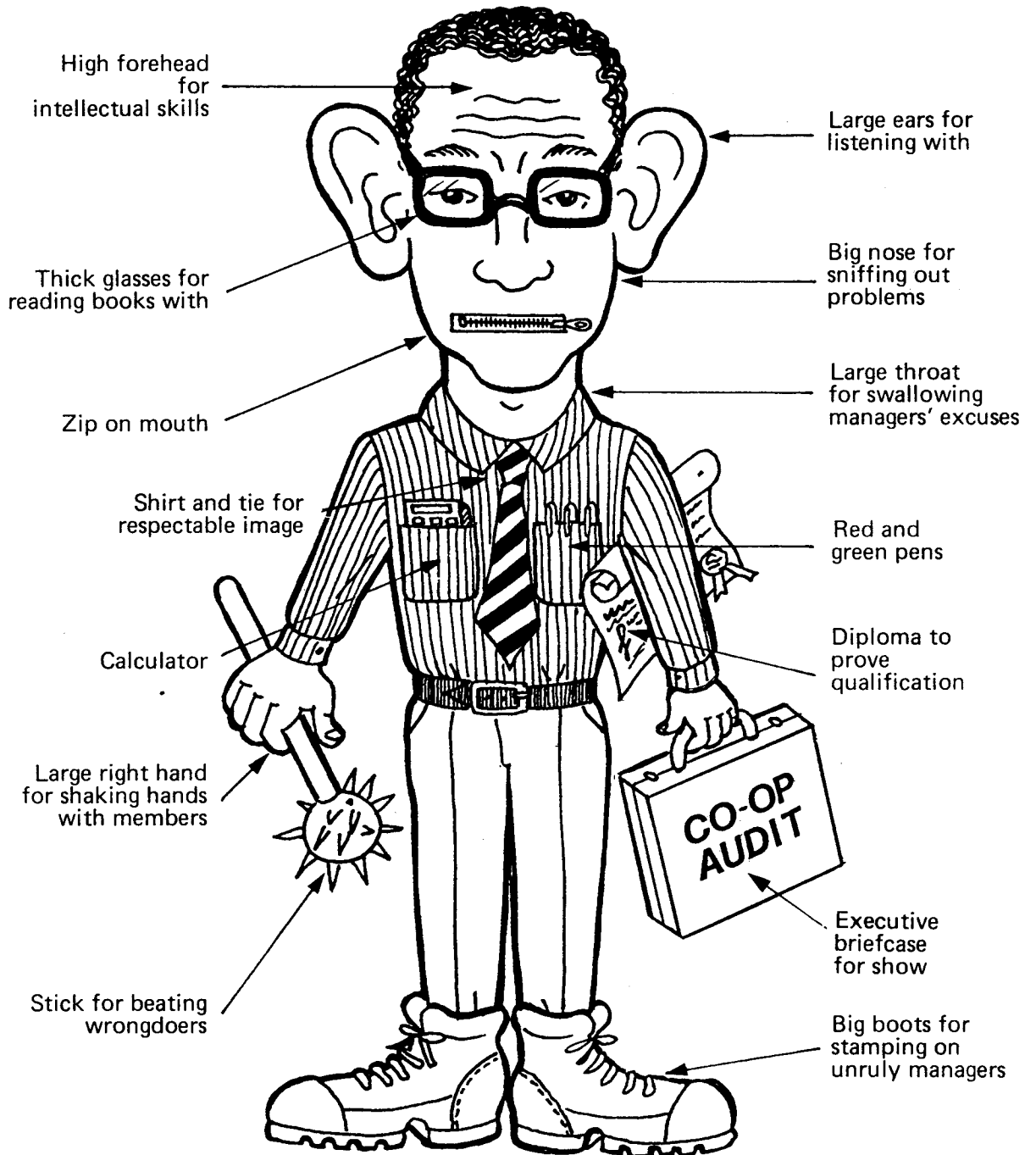
Independence and integrity can be considered as more of a state of mind and are more difficult to learn or prove.

You should stress that these qualities are more susceptible to rumour. The auditor must ensure that he does not give any reason for people to suspect that he lacks independence or integrity as this can soon be built

into disparaging and damaging comments.

If the auditors' credibility is affected then it is difficult for him to meet the principle objective of this work. The users of the accounts will not have confidence in the auditors' report nor in the accounts he is reporting on.

THE GOOD CO-OPERATIVE AUDITOR



Competence, Independence and Integrity

Assignment

Distinguish which characteristics are necessary and which are not. Give your reasons why.

topic

2

types of audit

Session 2.1 Internal Audit

Session 2.2 Other Types of Audit

SESSION 2.1

INTERNAL AUDIT

Objective : To enable trainees to recognise the concepts of internal auditing and to identify similarities and differences between internal and external auditing.

Time : 1 to 1/2 hours.

Material : Discussion Study "Auditors Arguing".

Session Guide :

- 1) It is likely that some of the trainees maybe internal auditors and they may feel that part of the first topic was not relevant to them. If this is the case you should point out that this course is dealing primarily with external audit but that there are many similarities between the two types of audit function.
- 2) Ask the trainees to distinguish the principal difference between internal and external auditors.

The answer should be based on the individual's employer. An internal auditor is employed by the co-operative he is auditing while an external auditor is employed by someone else.

The function of an external auditor is laid down by statute, whereas the functions of an internal auditor are determined by the management of the co-operative. The function of an external auditor is therefore precise while those of an internal auditor can vary widely depending on the requirements of management.

- 3) Display, on an overhead projector or flip chart, the following definition of internal auditing and ask the

trainees to discuss the content of the definition.

"Internal auditing is an in-house appraisal activity, which provides a service to management by examining the application and effectiveness of systems and controls within the organisation, in a manner that is independent of those operating the systems and controls".

- In-House: Carried out by employees of the co-operative.
- Appraisal: The internal auditor reviews the performance of others. He does not do the co-operative's productive work himself but checks the work of others and compares this with laid down procedures.
- Service of Management: The internal auditor ensures that management instructions and policies are being complied with through the correct application of systems and controls.
- Effectiveness: He reviews and checks whether the controls are meeting their objectives in an efficient manner.
- Independence: While being a member of the co-operative's staff, an internal auditor must be free from the influence of those on whom he is reporting. There is little point in an internal auditor being asked to report on the work of the Chief Accountant, if that person is the auditor's immediate superior. The internal auditor's independence is usually achieved by his reporting to the General Manager or a Management Committee.

- 4) Hand out the discussion study "Auditors Arguing" and give the trainees 20 minutes to consider the questions raised.

Get the trainees to discuss their answers to the questions and ensure that the following points are covered.

- a) Both Joe and Jenny have made valid points but only in a negative manner. To answer Jenny, internal audit is only one of the functions which assist management in carrying out their responsibilities effectively. It is not intended to replace the duties of management in relation to control.

In relation to Joe's argument, if the internal auditor does not have sufficient knowledge about banking he should acquaint himself with the system before commencing the audit. However, he must be independent of the co-operative, or the auditor's report would not be considered as reliable and credible by the account users.

There is no need for the external auditor to duplicate the work of the internal auditor as this would be costly and unnecessary. However, the external auditor must be confident that he can rely on the work of the internal auditor before he chooses to use it. He will achieve this confidence by examining the organisational structure of the internal audit department (with special concern for independence), by considering the qualifications and experience of internal audit staff and by examining the standard and content of reports emanating from the internal audit department.

From the above it can be seen that the two auditors have complementary aims which can best be achieved by co-operation rather than by opposition.

- b) The objectives of internal audit will be those set by the management and generally will try to ensure:
- Management policies are being carried out.
 - Systems are working.
 - The co-operative's assets are safeguarded.

The external auditor's objective is to carry out statutory requirements and to give an opinion on the truth and fairness of the accounts.

Obviously the two overlap as both are concerned with the safeguarding of assets and operation of control systems. Any difference is likely to be in the degree of importance attached to truth of the accounts.

If one of the management's policies is to present in the accounts the best possible financial situation, then the internal auditor may have a slightly different view of the truth than the external auditor who is likely to take a more conservative view. For example, if a debt is six months overdue, an external auditor might insist on a bad debt provision being made in order to give a "fair" position. In order to show the best possible position the internal auditor would not want to make this provision (unless of course he knew the debt definitely was bad). Nobody can tell which view in the end will be correct.

c) Advantages

- Internal Audit can provide a moral influence to promote efficiency. For example, they ensure staff follow systems and keep records up to date.
- Matters of principle are quickly brought to the attention of management and are dealt with promptly
- Errors can be corrected while the events are still fresh in the mind.
- Frauds may be detected at an early stage. Pre-audit function (e.g. checking documents before a payment is made) can prevent errors occurring.

d) Disadvantages

- The only disadvantage might occur in an inefficient internal audit department where the costs exceed the derived benefits, or where time is wasted by others simply to satisfy the request of the internal auditor.

- e) The external auditor can use the work of the internal auditor where he is satisfied that the work has been carried out by competent people who would give an unbiased opinion.

Sometimes the external auditor will not have the skills necessary to investigate technical details.

It is sensible not to duplicate work if this can be avoided but the external auditor cannot do away with all his testing just because internal audit say the area is operating correctly. A minimum level of testing by the external auditor is always required in any audit no matter how strong the internal audit section is.

- f) The external auditor should not rely on an internal auditor's work when:
- The external auditor doubts the competence of the internal auditor.
 - He suspects bias in a report.
 - He has been alerted to possible errors or fraud. If this is the case then the external auditor must carry out his own audit to ensure that these do not affect the truth or fairness of the accounts.

- 5) The arguments put forward by both Joe and Jenny are weak and narrow-sighted.

Each audit function should be complementary to the other external and internal auditors have common interests and co-operation, rather than conflict, is desirable.

A properly conducted audit, whether internal or external, results in:

- A higher degree of reliability in financial statements, whether for internal or external use.

- Material errors and frauds being discovered and corrective action taken.
- Improved accounting methods.
- Better internal controls.
- Employees taking more care in their work.

AUDITORS ARGUING

Joe is an internal auditor with the Unity Co-operative Bank which has a number of branches throughout the country. Jenny is an auditor with the Registrar's Department and has been auditing all types of co-operatives - including the Unity Co-operative Bank - for three years.

Joe and Jenny have been arguing about each other's duties and each claims to perform a more important function.

Jenny says that Joe's internal audit section costs more than the benefits gained from it. She says that senior management should be tough enough to ensure that staff perform their duties properly. If they need internal audit that only shows management is not doing its job properly.

Joe, on the other hand, argues that the Registrar's Department as external auditors do not have sufficient knowledge about banking or spend enough time at the bank to provide any valuable service. Joe claims that external auditors only duplicate the work of the internal auditors and that the internal auditors might as well write the audit report for the accounts as this would save everyone time and money.

Assignment :

- a) Evaluate the merits of Joe's opinion and Jenny's opinion.
- b) What are the objectives of internal audit and how does this differ from external audit?
- c) What are the advantages of internal audit?
- d) Are there any disadvantages?
- e) Can the external auditor use and rely on the work of the internal auditor to reduce his testing and costs?
- f) When should an external auditor not rely on an internal auditor's work?

SESSION 2.2

OTHER TYPES OF AUDIT

Objective : To enable trainees to identify the various types of audit which are performed by either internal or external auditors.

Time : 1 to 1/2 hours.

Session Guide :

- 1) Begin the session by asking the trainees to name as many types of audit functions as they can, and write up their responses on the chalkboard. You are not looking for answers about individual types of societies such as "Consumer Co-operative Audit and Horticultural Society Audit" but are looking for functions such as:

- Pre-Audit
- Post Audit
- Interim Audit
- Year-end Audit
- Final Accounts Audit
- Statutory Audit
- Systems Audit
- Operation Audit
- Administration Audit
- Management Audit
- Value for Money Audit
- Continuous Audit
- Investigations.

You may have to do some prompting to get a complete list and this is an opportunity to encourage all trainees to contribute. It may well be the case that trainees will provide additional types of audit not included above. Note that the terms are not exclusive and there can be a degree of overlapping between one type and another.

- 2) Spend some time discussing the definitions of the various types of audits identified and ensure that the trainees have an understanding of each. Bear in mind

that different countries use varying terms to mean the same thing. Ensure that the trainees are aware of these problems of definition and that there is need for clarity when discussing audit functions.

- a) Pre-Audit: The examination of documents prior to a transaction being completed. It is usually carried out by an internal auditor. For example, scrutinising a cheque payment for documentation, authorisation and coding, before final signature.
- b) Post Audit: The examination of documents after a transaction has been completed.
- c) Statutory Audit: The whole audit process resulting from legislation which requires co-operative accounts to be audited. It results in the auditor stating whether, in his opinion, the financial statements give a true and fair view of the co-operative's affairs.
- d) Interim Audit: The first stage of the statutory audit which normally takes place during the financial year being reported on. The interim audit tends to concentrate on examining the control systems in operation the cooperative.
- e) Year-end Audit: The second stage of the statutory audit which takes place on (or about) the last day of the financial year. Work includes stocktaking attendance, cash counts and inspection of assets.
- f) Final Audit: The final stage of the statutory audit which take place after the year-end. It seeks evidence that the financial statements give a true and fair view of the co-operative's affairs from a combination of work performed at interim, year-end and final audit
- g) System Audit: The examination and appraisal of an existing system with a view to determining whether the system meets its objective in an effective and efficient manner.
- h) Operational Audit: This is similar to systems audit

but tends to have a wider scope. It is an examination of a specific set of operations. For example, the operations of a Transport Department.

- i) Administration Audit: An examination and appraisal of administrative controls and procedures. In practice in a co-operative, administration audits often concentrate on the application of bye-laws and co-operative principles.
 - j) Value for Money Audit: Similar to systems and operational audits but this puts the emphasis on resources not being wasted. It asks the question "Are the objectives of the co-operative being met in the most efficient manner possible?"
 - k) Management Audit: The examination and appraisal of managerial objectives and policies with a view to determining the efficiency of management in relation to the needs of members.
 - l) Continuous Audit: The continuous examination by the auditor of systems and records throughout the year. External auditors will only be involved in this activity in very large co-operatives as it involves audit staff being at the client's premises for considerable periods of time.
 - m) Investigations: This is a situation where the auditors are called upon to examine certain aspects of a co-operative's operations, usually with a view to establish the cause and effects of mismanagement, fraud or financial losses. The scope of an investigation is usually defined and limited by instructions from the person instigating the investigation.
- 3) Ask one or two of the trainees to come forward and rearrange the lists, (with the assistance of the rest of the group), according to which group of people may undertake each type of audit.

It shouldn't take long for the trainees to realise that most of the activities can be undertaken either by internal or external auditors (or in some cases by external consultants). This should produce a table or diagram similar to the following:

Common Activities	External Audit Only
<ul style="list-style-type: none"> * Pre-Audit * Post Audit * Year-end Audit * Final Accounts Audit * Systems Audit * Operational Audit * Administration Audit * Management Audit * Value for Money Audit * Continuous Audit * Investigations 	<ul style="list-style-type: none"> * Statutory Audit

The only audit function that is exclusive to external auditors is a statutory audit. This is because of the need for independence. A person employed by the co-operative is unlikely to be considered by the users of the accounts to be sufficiently independent as to give an unbiased report.

Mention to the trainees that later in the course you will be discussing the specialised audit functions in greater detail.

topic

3

errors, fraud and waste

Session 3.1 Errors, Fraud and Waste

Session 3.2 The Auditor's Responsibility

SESSION 3.1

ERRORS, FRAUD AND WASTE

Objective : To enable trainees to identify and distinguish between errors, fraud and waste, and to evaluate the significance of each in relation to the accounts being audited.

Time : Three to four hours - plan to have a break during the session.

Material : Case Study "Chaotic Co-operative Ltd."

Session Guide :

- 1) Remind the trainees that although the primary objective of auditing is to give an opinion on the truth and fairness of accounts, this still requires the auditor to be able to detect and evaluate significant errors and frauds.
- 2) Ask the trainees to establish the difference between error, fraud and waste. Their comments should be along the following lines:
 - Error: an unintentional mistake.
 - Fraud (or embezzlement): a deliberate manipulation with the intent of financial gain.
 - Waste: inefficiency and extravagance which is allowed to occur through poor management.
- 3) A number of minor mistakes are unlikely to affect the relevance of the accounts but one major error could, if not detected and corrected, make the accounts misleading.

If an error is sufficiently large to alter the meaning of the accounts, this is called a material error.

A matter is material if its non-disclosure or misstatement would be likely to distort the view given by the accounts.

Ask of the trainees what they would consider to be the value of a material error.

For example: - Would the omission of a cash receipt of \$50.00 be important (or material)?
- Bad debts of \$5,000.00 not provided for?
- Stock overvaluation of \$50,000.00?

Depending on the individual you are likely to receive a wide variety of answers.

The point is that without other figures to compare with, it is not possible to make a judgement about materiality.

For example: - If the missing receipt of \$50.00 was at a thrift and loan co-operative with total receipts of only \$500, for the year then this would have an important impact on the accounts.

- If the bad debts of \$5,000 were at an insurance co-operative which had total debtors of \$20,000,000 then it is unlikely that the account users would be misled if a provision for \$5,000 was not included.
- Ask the trainees if they can think of examples of where the stock valuation error of \$50,000 is and is not material in relation to the accounts.

- 4) Trainees may be surprised that some errors are more important to the auditor than others.

Explain to them that every error is important in principle as it is a sign of poor control and could indicate the existence of other mistakes. However the auditor's

task is to establish whether the error affects the truth and fairness of the accounts.

This evaluation is often more difficult than finding the mistake in the first place.

- 5) Divide the trainees into groups of three or four and hand out the case study "Chaotic Co-operative Society Ltd." and answer frame.

Allow the groups about half an hour to read the study and compile their answers and comments.

Because trainees may have different views of how specific mistakes have arisen, it is not possible to give exact answers. However, the completed answer frame given at the end of the session guide provides an example of the approach required.

The level of materiality (whether an error is large enough to make the accounts misleading) depends on the figures in the accounts. Therefore all errors should be evaluated in comparison to the accounts.

Ask the trainees what they think a material value would be in the case of Chaotic Co-operative. This is a very difficult point to give advice on but at this stage in the course a rough guide could be given as follows:

- 5 to 10% of profits or = \$1,500 to \$3,000

Stress that this is only a rough guide as every audit is different the level of materiality may alter in each case. An alternative basis is to use a figure based on a combination of profit, turnover or capital employed.

Try not to spend more than 5 minutes on each point unless there is significant disagreement.

- A. This would appear to be a simple error. However it should always be remembered that when a fraud is

first uncovered it usually appears to be a mistake and it is only on further investigation that the true extent of the problem is uncovered. In this case the trainees should be asked to explain how the trial balance has been arrived at, and whether there is a compensating error somewhere else.

- B. It is an error that no receipts have been kept but there is the possibility that Ms. Singh has been taking some of the money.
- C. This is a major problem and as the fraud is larger than the stated profit it must be material. If the accounts are not altered then they must be misleading.
- D. An error which cannot be considered material.
- E. This is a case of inefficient management and nobody has tried to cover anything up. In the instances of waste, materiality is not usually a consideration as the accounts fairly record what has actually happened.
- F. Errors are common in this area, known in accounting terminology as "Cut-off" (The time around the end of an accounting period). The co-operative has paid but as they did not include the goods in the stock figure, the cost of sales is overstated and the profit understated.
- G. A wage clerk who says he doesn't understand the system is immediately suspect!
- H. Probably a case of waste through use of undertrained staff.
- I. An increase in consumption of this magnitude might be possible if the co-operative had to use a ten tonne truck instead of the pick-ups which were written off. However, judging from the value of vehicles

given in the accounts (\$300,000) there must be a sufficient number of vehicles to avoid this and the assumption must be that something is going on.

- J. Error, not material, especially as it does not alter the reported profit.
- K. It might be interesting to ask the board members about this but it appears only to be a case of extravagance.
- L. Waste, probably caused by the new telephonist misusing the phone. Management should be informed but this does not affect the truth of the accounts.
- M. This is likely to be an example of what is known as "teaming and lading" or "lapping".
- N. Probably fraud. The amount is not material but the implications with regard to the cashier are very serious.
- O. An administrative error, but one which could have serious repercussions. The bank may withdraw the lending facility or charge a higher interest rate.
- P. The members would soon complain if they did not receive the interest when they are entitled to it. It is likely that this is an oversight.
- Q. The General Manager must be suspect! Further testing should be undertaken to establish the full extent of the problem. On this point, ask the trainees how they calculated the value of the error. Remember Ramesh Gupta was testing a sample of 10% and this error must be evaluated as if it occurs in the total balance.

This can be done as either in relation to the number of members holding deposits -

$$\begin{array}{r} 300 \text{ members} \\ \hline \end{array} \times \$2,300 = \$23,000$$

30 sample

or in relation to the value tested -

$$\begin{array}{r} \$250,000 \\ \hline \end{array} \times \$2,300 = \$19,040$$

\$30,200

- R. This is an administrative error which has no effect on the accounts.
- S. The co-operative is not losing anything by this action but the taxman is. This is a question of moral judgement. One option would be to ask the board to alter the Manager's contract if they think this is suitable.

Overall this is a dreadful co-operative from the point of view of lack of control and the accounts as presented would be totally misleading. At least 6 out of 22 points raised by Ramesh Gupta are important enough to affect the sense of the accounts.

Point out that auditors working in the same department should try to work towards similar standards if their work, is to be of objective value. There is little use in one auditor considering something vitally important if his associate would dismiss it as being of no significance.

- 6) Ask the trainees to consider the types of errors of frauds which are more likely to happen at the various types of co-operatives that they audit. For example, the greatest risk for credit societies is likely to be embezzlement of funds. Stock losses are likely to arise at consumer co-operatives. Auditors should be aware that certain types of society are more susceptible to one kind of fraud or error than others.

CHAOTIC CO-OPERATIVE SOCIETY LTD.
Evaluation of Errors

	Value of Mistake \$	Error	Fraud	Waste	Material	Not Material
A	180	*				*
B	NIL ?	*	?			*
C	31,250		*		*	
D	225	*				*
E	2,000			*	N/A	N/A
F	12,150	*			*	
G	1,000 app.		*		* ?	* ?
H	20,000			*	N/A	N/A
I	50,000 app.		*		*	
J	560	*				*
K	10,000 app.			*	N/A	N/A
L	1,500 app.			*	N/A	N/A
M	4,000 +		*		*	
N	200		*			*
O	NIL ?	*				*
P	12,500	*			*	
Q	20,000 app.		*		*	
R	NIL ?	*				*
S	NIL ?		?			*

CHAOTIC CO-OPERATIVE SOCIETY LTD.

Ramesh Gupta has returned to the Audit Department's Office after spending a week auditing the Chaotic Co-operative Society. This is an agricultural supply co-operative which provides inputs to farmers throughout the country. He was surprised at the number of errors he found. He has prepared the attached report for evaluation by you, the Head of Audit.

Assignment

1. State whether you think each of the examples relates to:
 - a) Error.
 - b) Fraud.
 - c) Waste.

2. Do you think that individually, the mistakes affect the 'truth and fairness' of the accounts? In other words, would these be 'material' to the users of the accounts if they were not corrected?

To: Head of Audit
From: Ramesh Gupta
Date: 11 October 1991
Subject: Chaotic Co-operative Society Ltd.
Year end: 30 June 1991

Please receive my report on the errors found during my audit of the Chaotic Co-operative Society Ltd.

Income and Expenditure Account Year to 30 June 1991

Turnover		\$3,250,000	
Cost of Sales		<u>\$2,750,000</u>	
Gross Profit		\$500,000	18%
Salaries and Wages	\$115,000		
Transport	\$225,000		
Administration	\$75,000		
Depreciation	\$40,000		
Bank Interest	<u>\$15,000</u>		
Total Expenditure		<u>\$470,000</u>	
Net Profit		<u>\$30,000</u>	1%

CHAOTIC CO-OPERATIVE SOCIETY LTD.

Balance Sheet as at 30 June 1991

Vehicles	\$300,000	Bank Loan	\$200,000
Buildings	\$50,000	Bank Overdraft	\$10,000
Stock	\$300,000	Creditors	\$90,000
Debtors	\$145,000	Members' Deposits	\$250,000
Cash	\$5,000	Share Capital	\$50,000
		Reserves	\$200,000
	<u>\$800,000</u>		<u>\$800,000</u>

- A. The trial balance contained a posting error of \$180.
- B. A number of vouchers relating to office sundries could not be traced (these totalled \$473.88). Ms. Singh said that these relate to purchases of milk from a nearby farm for the morning and afternoon coffee.
- C. Stock of fertiliser was overstated by 5,000 bags at a

value of \$6.25 each. It appears that the store-keeper was trying to cover-up a shortage for which he was responsible.

- D. Stock of Farm Carts were valued at \$565.00 each but this was the old rate. All the stock (15 carts) related to the most recent delivery which cost \$580.00 each.
- E. Rain entering through a hole in the roof of the store caused damage of \$2,000 to hessian sacks, which were written off. The hole had not been repaired for 18 months.
- F. Goods in transit (20 tonnes seed dressing) were not included as assets in the accounts although \$12,150 was paid for these goods on 25 June 1991. The goods arrived on 5th July.
- G. A number of overtime payments could not be supported by timesheets. I estimate 10% of all overtime payments fall into this category. The wages clerk claimed that he did not understand the system properly and was confused.
- H. Two pick-up trucks valued at \$10,000 each were crashed and written off during the year. Neither driver had a licence.
- I. Diesel usage has increased to 1 litre for every 2.8 km. travelled compared to 1 litre for every 4.5 km. in 1989 /90. Total diesel purchases amounted to \$150,000 during 1990/91.
- J. An amount of \$560 was charged to cost of sales instead of the transport account.
- K. The General Manager has purchased for his office a luxury carpet and exclusive imported furniture. The manager says this was approved by the board when they passed the budget which included \$10,000 for 'unspecified contingencies'.
- L. The office phone bill has doubled to \$3,450 over the

year although there have not been any tariff increases. This has coincided with the employment of a new telephonist.

- M. An outstanding bank deposit of \$4,000 did not appear on the bank statement until 10 days after the year end. It is common for there to be a fortnight's delay between cash being received and it being credited to the bank account.
- N. A personal cheque from the cashier of \$200 was in the cash box at the year end but the cheque has never been banked.
- O. The bank loan agreement expired on 31 March 1991 and has not been renewed.
- P. The Bye Laws state that interest of 2% below the official bank rate will be paid on members' deposits. The current bank rate is 7% but no interest has been paid.
- Q. I contacted 10% of members who held deposits with the co-operative and on checking passbooks found the following:
- | | | |
|-----------------------------|---|------------|
| Sample | - | 30 members |
| Value recorded in passbooks | - | \$32,500 |
| Value in society ledger | - | \$30,200 |
- There were differences in 8 passbooks and all represented amounts deposited between 1 March 1991 and 15 May 1991. During this time the clerk who is normally responsible was in Europe on training and the General Manager was covering his duties.
- R. The minutes of the Special General Meeting held on 15 November 1990 have not been entered in the minute book. This meeting was held to elect a new chairman.
- S. The General Manager's salary is set at \$1,000 per month and no mention of allowances is made in his contract.

His June payslip was calculated as follows:

- Salary	\$500	Pension (10%)	\$50.00
- House Allowance	\$250	Tax (25%)	\$125.00
- Travel Allowance	<u>\$250</u>		
Gross	\$1,000		\$175.00
Net		\$825.00	

CHAOTIC CO-OPERATIVE SOCIETY LTD.
Evaluation of Errors

	Value of Mistake	Error	Fraud	Waste	Material	Not Material
A						
B						
C						
D						
E						
F						
G						
H						
I						
J						
K						
L						
M						
N						
O						
P						
Q						
R						
S						

SESSION 3.2

THE AUDITORS' RESPONSIBILITY TOWARDS
ERRORS, FRAUD AND WASTE.

Objective: To enable trainees to decide what action the auditor should take when he comes across cases of errors, fraud or waste.

Time: 1 to 1 1/2 hours.

Material: Role Brief "Audit Interview".

Session Guide:

- 1) Begin the session by selecting two of the trainees to act out the role briefs of Mr. Chow and Mr. Hong respectively. Give them a copy of their briefs and tell them that at the end of the interview they must have decided on what action to take on each of the points highlighted in the brief.
- 2) Write on the chalkboard or flip chart what was decided by the two trainees about each of the following points.
 - A. Can Mr. Chow sign the accounts as 'true and fair' in their present state?
 - B. Is it the auditor's fault that Mr. Ching's fraud was not discovered for three years?
What should be done regarding the \$10,000 which appears to have been stolen by Mr. Ching.
 - D. Is the shortfall in income of \$350 a material amount in relation to the accounts?
 - E. What should be done about this and the poor record-keeping during Mr. Hong's absence?
 - F. Should the auditor support Mr. Hong in his effort to have Mr. Wang dismissed?

- G. Is the accounting policy in respect of office furniture correct or should it be changed?
 - H. What action should be taken regarding the overspending on office furniture?
 - I. Was the auditor clerk Xuhou wrong to query the General Manager's travelling expenses because receipts for taxis were missing?
- 3) Ask two more trainees to play the roles of Chief Auditor and General Manager and see if they can bring out the points mentioned above. This time let the remainder of the trainees participate if they disagree with what is being said by the role players.
- 4) Ask the trainees to discuss each of the points raised in section 2 above and try to guide them with the following comments:
- A. At present the auditor would have to 'qualify' his report as the missing cash is significant in relation to the profit for the year.
 - B. Usually Co-operative Laws state that it is the Board (or Member's Committee) that is responsible for safeguarding the assets of the co-operative. In theory they should take the blame for this loss but in practice they delegate their responsibility to the management.

The auditor is not blameless for not detecting the fraud but if anyone should accept responsibility it should be Mr. Hong who has not operated effective controls.
 - C. An investigation should be undertaken to indentify the amount that is missing and this should be provided for in the accounts.

The auditor should advise the General Manager that the police be contacted and an attempt made to trace Mr. Ching and recover the missing amount. If this

can be done there would be no need to alter the accounts.

- D. \$350 would not be a material amount.
- E. Perhaps the members who have received incorrect premiums could be contacted and be asked to pay the full amount. In a co-operative it should be possible to do this in the interests of all the members. Mr. Wang could be asked to make up the shortfall.

Detailed "stand in" procedures must be set up when Mr. Hong next goes on leave, to ensure that similar errors cannot happen again.

- F. It would not be correct for Mr. Chow to support the manager in asking for Mr. Wang's dismissal. As far as the auditor is aware the problem is inexperience and lack of training, not incompetence. Education would appear to be a better solution than dismissal.
- G. It seems that the reason for the policy of writing off office furniture in the year of purchase is because it is not expected to last much longer than a year. If the imported furniture will last significantly longer, there is no reason why the policy cannot be changed.

Accounts should normally be consistent - that is to say the same accounting policies should be maintained from year to year. However if circumstances have changed it may be correct to adjust the accounting policies.

In this case, if a three-year depreciation policy can be justified then the profit would be increased by \$8,000. Most likely this should be enough for Mr. Hong to accept the need for a provision against the theft by Mr. Ching and both parties would be satisfied.

- H. The auditor has little choice but to report this overspending to the Board of the co-operative. Mr.

Hong would then have to justify his expenditure to the Board.

- I. As it was not on Mr. Chow's list of points it can be assumed that he is not worried by this matter in relation to the accounts.

The audit clerk was not wrong but may have been a little tactless with his questions. Senior managers do not like being asked what they consider to be impertinent questions by junior clerks, even if they are auditors. Mr. Chow should be proud of the zeal of his staff but apart from pointing out that Xuhou was within his rights to ask the questions, Chow should not argue on this point. There are more important items to be dealt with.

- 5) If you consider it useful and if there is time available, ask another two trainees to enact the role-plays.
- 6) When summarising the session remind trainees that the principal audit objective is giving an opinion on the truth and fairness of accounts. However, if there is a material error which is not detected, the auditor may be accused of negligence and can be sued in court. The trainer should emphasise this point of negligence, if possible using local examples.

It is not the auditor's task to find every error or fraud, only those which have a material effect on the accounts. If the auditor finds an error or fraud which he considers to be material then he must take action by either having the error corrected or by 'qualifying' his report.

Apart from this he is only an adviser and he should pass on his advice to the appropriate persons whether these be the management, the co-operative board or the members of the co-operative. These are the people who should decide what action to take, not the auditor.

AUDIT INTERVIEW

The Co-operative Audit team have finished their work at "Safe and Secure Co-operative Society" which is an insurance co-operative. Generally the audit has progressed well but there are a few points that have to be cleared up before the Head of Audit signs the audit report for 1991.

Mr. Chow, the Head of Audit, had decided to meet Mr. Hong the General Manager of the Co-operative. He wants to make some changes in the accounts and to discuss other points which, although not directly affecting the "truth and fairness" of the accounts, could be important in the future.

The accounts for the last three years have shown surpluses of .

- 1989/ \$100,000) In accordance with the bye-laws,
- 1990/ \$108,000) dividends of 50% of surpluses
- 1991/ \$110,000) have been paid to members in proportion to premiums paid.

ROLE BRIEF 1

You are Mr. Chow, Head of Co-operative Audit, and have responsibility for signing the audit report of "Safe and Secure Co-operative Society". During the course of the audit your staff have discovered the following:

For the last three years, Mr. Ching the society's cashier, has been keeping a second Cash Book. An estimate of the amount of cash missing is \$10,000. No adjustment in the accounts has been made for this as Mr. Ching has disappeared and the exact amount has not been determined.

While Mr. Hong the manager was on leave for a month, his deputy (Mr. Wang) made a number of mistakes while issuing insurance policies. The overall effect of this was the loss of \$350 of insurance premiums while still ha-

ving to give the members concerned the appropriate cover. Some of the record keeping during this time was rather untidy. Although the auditors had to spend extra time on this area you are happy these were genuine mistakes by Mr. Wang which were caused by inexperience and lack of adequate training.

Mr. Hong, the General Manager, has recently purchased a new suite of expensive imported furniture for his office. Although new furniture was approved by the committee, the amount spent (\$12,000) was 50% above the amount approved. In accordance with the co-operative's accounting policies, office furniture is written off in the year of purchase.

ROLE BRIEF 2

You are Mr. Hong, the General Manager of Safe and Secure Insurance Co-operative which has recently been audited by the Co-operative Audit Team. You have been General Manager for 10 years and consider you know almost everything there is to know about your business.

The Head of Audit has asked to meet you regarding a number of points arising from the audit, and you have a number of your own which you wish to discuss.

You want to know why the auditors took three years to find out that Ching the cashier was operating a second cash book and might have stolen \$10,000. As this amount hasn't been proved yet, you see no reason to provide for this in the accounts as it would severely reduce the surplus which has already been dented by the cost of your new office furniture. You are proud of your record of increasing dividends to members every year since you took over as general manager and do not want to have a reduction this year.

You do not understand why office furniture is written off in the year of purchase when even the last purchase (of poor quality local furniture) lasted almost two years before it started to fall apart. One of your reasons for purchasing imported furniture was that it would last at least three years.

Mr. Wang, your deputy manager, made some silly mistakes while you were away on holiday and you want to know if the auditor will back your attempt to get the member's committee to dismiss him. Wang is always pestering you for assistance and advice and you don't have time to deal with this.

You want to complain about that young auditor, Xuhou, who had the cheek to query some of your travelling expenses saying that receipts should be obtained for all expenses, even taxi fares!

topic

4

internal control

- Session 4.1 The Need for Control
- Session 4.2 Types of Internal Control
- Session 4.3 Cost/Benefit of Internal Control
- Session 4.4 Evaluation of Control

SESSION 4.1

THE NEED FOR CONTROL IN A CO-OPERATIVE

Objective : To enable trainees recognise the need for internal control in the organisational systems and operations of a co-operative.

Time : 1 and 1 1/2 to 2 hours.

Material : Case Study "Busy Bee-keepers" Co-operative Society Ltd.

Session Guide :

- 1) Every activity or organisation has a set of rules by which it operates. These are usually recorded in some form of constitution or manual but in some cases it may simply be an informal code of conduct.
- 2) Ask trainees if they can put a name to the set of rule by which various types of activities operate.

For example, a football match is usually organised under Football Association rules, but a game of football on the beach may ignore technicalities such as "off-side".

Give the following as examples and see if the trainees, on the basis of their own experience, can expand on them.

<u>Activity/Organisation</u>	<u>Rules</u>
- Political Party	- Constitution and Manifesto
- Civil Service	- Standing Orders
- Game of Monopoly	- Written Instructions
- Running a House	- Informal Task Allocation
- Language	- Grammar

Although the rules will conform to some general principles, each activity will have specific features to suit

individual circumstances.

- 3) In the same manner any co-operative will have a set of rules to guide its operations.

Ask the trainees to state the rules or systems under which co-operatives operate and write their replies on the chalkboard.

These should include:

- Co-operative Principles.
- Statutes and Bye-laws.
- Managerial (including accounting) systems.
- Policies set by the Board.
- Conditions of Service (for staff of larger co-operatives).

Get the trainees to rank their replies in order of importance to an auditor and discuss the reasons for their ranking.

It doesn't really matter which one the trainees decide to put first; however, the reason should be that they consider this item to be the most important in achieving the principle objective of the auditor - that the operation of the rules will result in the auditor being able to state that, in his opinion, the resultant accounts give a true and fair view.

In the majority of cases it is likely to be the managerial and accounting systems that will be of most significance to the auditor.

- 4) From the above it can be seen that the accounting system is only part of the "rules" which guide the operations of a co-operative. These "rules" are known as the "internal control system" which can be defined as:

The whole system of controls designed to allow the co-operative to operate in an orderly and efficient manner, to ensure complete and accurate records, to

safeguard the assets and to ensure adherence to co-operative principles.

5) Hand out the case study "Busy Bee-keepers" Co-operative Society Ltd. and ask the trainees to read it and consider their answers for 15 to 20 minutes.

a. Reasons for the Commissioner insisting on a proper book-keeping and control system.

- Most co-operative acts will include a provision that requires proper records and accounts to be kept. This is to ensure the following;
- That all transactions are recorded and that they are recorded correctly and accurately;
- To enable accurate accounts to be prepared;
- To safeguard the assets of the society;
- To protect the interests of the members;
- As this is a new society it should, in the future expand. This expansion will necessitate record systems that can cope with the additional transactions.

Referring to the previous topic you should remind the trainees that the co-operative must guard against the possibility of:

- Unintentional errors
- Fraud
- Waste and extravagance.

This can only be achieved if adequate control systems are being operated.

b. Transactions and possible errors - this is a deliberately vague question which should allow the trainees to use their imagination. They must try to imagine how the society will operate and then what might go wrong.

You should try to help the trainees achieve a struc-

tured approach rather than them giving a series of haphazard answers. Begin by asking what sources of income the co-operative will have.

- Entrance fees and shares.
- Sale of honey jars.
- Levy on members' produce sales.

These types of income could either involve cash or some form of credit. Without proper systems, income could be omitted, cash could go missing, debtors could be incorrectly recorded, stocks could be lost etc. The trainees should be able to give a variety of possibilities of what might go wrong.

After you have discussed sources of income, move on to types of expenditure. Again the trainees should be able to provide many examples and suggestions as to how things could go wrong if the book-keeping systems were inadequate.

- c. There is only one cost that must be involved and that is not even a financial one.

It is time. The members' time and the time of the Commissioner and his staff.

Everything else could be (but is unlikely to be) donated free by members or other interested parties.

Often when co-operatives are first formed they are short of funds and one of their priorities is to keep overhead as low as possible. This includes expenditure on book-keeping and other controls. The Commissioner of Co-operatives should be able to provide the basis of an adequate book-keeping system at no charge, which can use low-cost, simple stationery.

- 6) Based on the trainees' replies to the possible transactions of the co-operative, discuss what book-keeping records might be suitable for the "Busy Bee-keepers" Co-

operative Society Ltd. These should include:

- Cashbook
- Record of sales of honey
- General Ledger
- Members Ledger
- Debtors' Records
- Stock Register.

7) Discuss what type of internal controls might be suitable for the "Busy Bee-keepers" Co-operative Society Ltd.

These might include:

- Organisation structure defining responsibilities;
- Joint cheque signatories (Treasurer and Chairman);
- Bank and cash reconciliations prepared by the Treasurer and checked by another committee member;
- One person being responsible for issuing levy charge invoices and another responsible for receiving and recording in money;
- Only one person having a key to the store where the honey jars are kept;
- Monthly report of activities to all members.

8) To close the session, remind trainees that a co-operative like any other type of group activity, need a set of rules to govern its operations.

Part of these rules will include instructions on the accounting systems that are required for the society's successful operations.

The auditor must be interested in the operation of the controls as he is concerned with the possibility of material errors or frauds affecting the accounts.

"BUSY BEE-KEEPERS" CO-OPERATIVE SOCIETY LTD.

A group of bee-keepers have decided to strengthen their previous informal marketing arrangements and feel that this can best be achieved by forming a co-operative society. They have applied to the Commissioner of Co-operatives for registration.

To begin with, the function of the co-operative would be to arrange the bulk purchase of honey jars which would be resold to the members as required. The co-operative would also co-ordinate the supply of honey to retailers under a single brand name and would cover any costs by levying a small margin on each transaction. The business of the co-operative would be carried out by an elected committee which initially would meet one afternoon every week.

The Commissioner has studied their application and draft Bye-laws. He considers that the proposed society will be viable and has potential for growth. The members appear to be committed and should benefit significantly from closer co-operation.

At a meeting between the Commissioner and the members, the Commissioner said he would agree to register the society once he was satisfied with the book-keeping and control system they proposed to use.

The members who hadn't given this matter much thought said they would accept any system recommended by the Commissioner provided that there was no cost involved. They did not want to employ anybody or purchase expensive stationery. The members felt that as it was a co-operative being run for the benefit of all members, there should not be any book-keeping (or financial) problems.

Assignment

- a) State what reasons should the Commissioner give to the members for insisting on a proper book-keeping system, even though this is likely to involve some cost to the society?
- b) What transactions are going to have to be covered by the system and what may go wrong if the system is inadequate?
- c) What cost must be involved?

SESSION 4.2

TYPES OF INTERNAL CONTROL

Objective: To enable trainees to explain the need for different types of internal control systems in a co-operative, their costs and benefits and the need to evaluate these control systems as part of the auditing process.

Time: 2 to 2 1/2 hours.

Material: "Super Co-operative - Till Operations".

Session Guide:

- 1) In the previous session you have established that an organisation system is necessary to ensure that the business of the co-operative is carried out in an efficient manner.

The system will include a number of controls which help safeguard the assets and ensure complete and accurate book-keeping by reducing the possibility of errors or fraud.

As will have been noted from the previous session, this is known as an Internal Control System.

- 2) Ask the trainees why the existence and effectiveness of internal controls is very important to auditors.

If an effective control system is in place there is less likelihood of the accounts being misleading either deliberately or otherwise.

- 3) Controls can be divided into a number of different types. Ask the trainees if they can suggest headings for types of control. Lead them towards the following which you could list on the chalkboard.

- Organisation
- Segregation of Duties
- Arithmetical
- Authorisational
- Acknowledgement of performance
- Personnel
- Checks
- Physical
- Managerial Analysis
- Supervision

Discuss briefly how each type of control might work. It is not necessary to go into the details of each at this point as this should be brought out in the worksheet. However you should be aware that controls may overlap definitions.

- 4) Hand out the "Super Co-operative - Till Operations" Sheets.

Explain to the trainees that there are many types of controls in operation at "Super Co-operative" and these often are not simply financial controls. Tell them that the point of the worksheet is to identify these different types of control, but there may be some which overlap two types. The examples given below are only intended to serve as guides; the trainees may disagree with some of the classification of types. This is quite acceptable if they are able to justify their views.

Go over the introductory paragraphs with the trainees and make sure that they are clear about the basic operations of a large co-operative supermarket.

Many of the controls on the worksheet are obvious but the trainees may not be aware of the purpose of each. You should encourage discussion about how each activity safeguards the assets of the co-operatives or reduces the possibility of error or fraud.

CONTROL	TYPE
<p>A. i) Staff arrive half hour before the shop opens</p> <p>Principally this is to avoid staff being late but also if there is a rush at the start of the day there is an increased possibility of mistakes.</p>	<p>Organisational</p>
<p>A. ii) Cashiers carry no money of their own in the shop</p> <p>Any cash in the shop belongs to the co-operative There can be no arguments about excesses if they arise.</p>	<p>Physical</p>
<p>A.iii) Supervisor puts in till roll and locks it in the machine</p> <p>The cashier has no access to it and is not responsible for the till roll. He cannot make alterations which might cover errors or fraud.</p>	<p>Segregation of Duties</p>

CONTROL	TYPE
<p>B. i) Manager issues float</p> <p>It might be assumed that the float has come from the safe and that the manager is the only person with a key for it.</p>	<p>Segregation of Duties</p>
<p>B. ii) Cashier signs for float</p> <p>There can be no argument about the starting float if there are differences at the end of the shift.</p>	<p>Check</p>

CONTROL	TYPE
<p>C. i) Supervisor decides break time</p> <p>Cashier cannot disappear when he feels like it.</p>	<p>Supervision</p>
<p>C. ii) Cashier lock till at break times</p> <p>No one else can get at the cash. The responsibility remains with the cashier.</p>	<p>Physical</p>

CONTROL	TYPE
D. i) Takings entered on Takings Sheet These will be added up as part of the reconciliation process at the end of the day.	Arithmetical
D. ii) Both count cash and sign To reduce possibility of errors or disputes.	Checks

CONTROL	TYPE
E. i) Authority for cheque payment is in members' passbook Bounced cheques are a problem for any organisation and this ensures that proper authorisation is received. Members will be known to management who have authorised the transaction and set limits.	Authorisation
E. ii) Member's number written on cheque and supervisor confirms details	Authorisation/Supervision
E.iii) Staff are properly trained It is essential to have competent, trained staff.	Personnel

CONTROL	TYPE
F. i) Supervisor alters till roll Cashier is not able to interfere with the arithmetical control provided by the till roll.	Segregation of Duties

CONTROL	TYPE
G. i) Store detective system operating The cashier and supervisor are less likely to be involved in misdeeds if they are aware that another person is checking up on them from time to time. One of the most difficult things in fraud prevention in a supermarket is to stop cashiers from forgetting to ring up sales to their friends. A store detective operating as a kind of 'internal auditor' is often used to help prevent this.	Organisational

CONTROL	TYPE
<p>H. i) Cashing-up reconciliation</p> <p>Cash is compared to till roll records and differences are investigated immediately. Two people with responsibility for each part of the operation are involved - the cashier has control of the cash and only the supervisor has access to the till roll.</p>	<p>Arithmetical</p>
<p>H.ii) Over and User record</p> <p>If cashiers have to acknowledge their errors they are continuously aware of their performance and will want to avoid salary deductions.</p>	<p>Acknowledge of performance</p>

CONTROL	TYPE
<p>I. i) Review of management</p> <p>Management can spot trends quickly. For example one cashier may develop a high rate of shortages and the reasons for this can be investigated and solved quickly. If sales recorded by one cashier suddenly drop, this could indicate a personnel problem which could also be settled quickly.</p>	<p>Management analysis</p>
<p>I.ii) Letting staff know that their performance is being monitored</p> <p>If staff know that someone is taking an interest in their work, they will be encouraged to perform to the best of their abilities.</p>	<p>Personnel</p>

- 5) Point out to the trainees that most of controls at the "Super Co-operative" revolve round the segregation of duties and the allocation of responsibility for specific functions.

For example, it is solely the cashier's responsibility is to ensure that the cash handed over to the supervisor is correct. The supervisor is responsible for the till rolls and the cashier cannot alter these. Only the manager handles the cash floats at the beginning of the day.

In each case the controls directly relate to protecting the assets of the co-operative or ensure that the records are accurate and complete. The system is designed to prevent error and frauds and at the same time provides evidence of the operations of the supermarket which the auditor will require for his work.

SUPER CO-OPERATIVE - TILL OPERATIONS

Mo is a till operator at "Super Co-operative's" branch in the centre of town. It is modern and the largest supermarket in town selling a wide range of consumer goods. At times it gets very busy and all 5 cash registers have to be in operation together to cope with the rush. Super Co-operative is open from 8.30 a.m. to 7.00 p.m., six days a week, and because of this they work a shift system on the tills.

Listed below are extracts from a typical day for Mo at the shop. You are required to identify the internal controls (if any) operating at each stage and discuss how these controls benefit the operations of "Super Co-operative."

- A. Mo is on the early shift and arrives at "Super Co-operative" right on time at 8.00 a.m. He changes into his cashier's overall and makes sure his own money is secure in his locker. By 8.15 a.m. he is at his till, where the shift supervisor locks in a new till roll and zeroes the register.
- B. At 8.20 a.m. the manager comes round the tills with the \$100 opening float for change. Mo counts his float and signs the manager's float sheet. He is now ready for the store to open.
- C. Business is quiet to start with and the supervisor lets Mo go for a break at 9.30 a.m. Before he goes he makes sure he has securely locked the till and the supervisor confirms this.
- D. When he returns, the shop is much busier and his till soon fills up. He asks for the supervisor to collect

some money and she takes \$500 which they both count and Mo signs the supervisor's "Takings Sheet" for the records.

- E. Shortly after this Mr. Smeed asks if he could pay by cheque. Super Co-operative's Board had recently changed their "Cash Only" policy, so Mo says "Certainly, Mr. Smeed, can I see your member's passbook please". Mo then went recalls the procedure he had been taught at the staff training course the month before. One of the things he liked best about working for "Super Co-operative" was that whenever there was something new they made sure that the staff were properly trained in the new methods. Mo examines Mr. Smeed's passbook and sees that he is authorised to pay by cheque up to \$100. He examines the cheque (which was made out for \$45) and writes Mr. Smeed's membership number on the back of the cheque. Mo then calls the supervisor for final authorisation of the cheque.
- F. The next customer finds she doesn't have enough money to pay for everything and has to put some butter back. This means that the receipt has to be altered and this is done by the supervisor, who also alters the copy of the till roll and signs both the receipt and the alternation.
- G. Mo thinks he sees the area store detective but doesn't get a chance to look properly when he looks again he can't see him. Mo wonders about the rumours of the detective catching more cases of theft by staff than by customers.
- H. At the end of his shift, Mo counts his cash and cheques ready for the supervisor to "cash up". The supervisor checks the register total and takes out the till roll. She enters the total in the "Register Totals Book" and then checks the cash and cheques which Mo gives to her.

Once they agree on the amount, the "Takings Sheet" is updated and Mo signs the sheet. They then reconcile the "Register Total" with the "Takings" allowing for the initial float and the altered receipt. Mo is \$2.33 short for the shift and this is entered on the "Overs and Unders" record which Mo also signs. Mo is aware that the shortage will be deducted from his salary.

- I. Shortly before Mo leaves for the day, Mrs. Jines the shop manager asks Mo to come into her office. She tells him how pleased she is with his work and explains that the weekly review of till takings shows that last week he moved into first position in total sales, and that his total shortage for the week was only \$5.78, putting him in line for the monthly prize for the lowest figure.

SESSION 4.3

COST/BENEFIT OF INTERNAL CONTROL

Objective : To enable trainees identify the cost/benefit relationship of controls.

Time : 1 1/2 to 2 hours.

Material : Case Study "Super Co-operative" (Session 4.2)
Case Study "Better Beef Co-operative Society"

Session Guide :

- 1) Remind trainees how co-operatives require controls which regulate the business, safeguard assets and ensure completeness and accuracy of records.

These controls vary depending on the type of co-operative and on the scale and size of operations. In the previous session you saw how "Super Co-operative" had quite a complicated system for the till operations of the supermarket. "Super Co-operative" had a large number of staff and handled large sums of cash daily.

Ask the trainees if they think the same sort of controls would be operated in a supermarket which only employed two cashiers? Discuss what they think might be appropriate in this situation.

The same principles will apply but there will be much less scope for allocation of responsibility and for segregation of duties. The small co-operative would probably not employ a shift supervisor and her duties would be shared between a senior cashier and the manager.

Ask if the scope for error is likely to be greater or less in the small co-operative.

It is of course only possible to give general answers to

this. Although the control system would be weaker, the lack of segregation could well be compensated by the manager being more aware of everything going on in the co-operative.

In a large organisation, senior management are not usually directly involved in the daily routine and problems will take longer to come to their notice than in a smaller shop.

There would be no point in the small co-operative trying to duplicate the control system of "Super Co-operative" as this would involve unacceptable costs.

- 2) What do the trainees think the cost of a control system would be?

Refer back to "Super Co-operative" and ask if the trainees can identify costs that are being incurred.

They will probably pick out the cost of the store detective as this should be easy to calculate. Ask what benefit is derived from his employment and how can this be compared to the cost of his salary and benefits.

Presumably the management feels that losses are reduced by at least as much as his costs. Point out that "Super Co-operative" employ an area store detective and therefore it can be assumed that the management do not consider the cost of a store detective for that branch alone as being justifiable.

Another cost that might be mentioned is lockers for the staff. What portion of this cost is caused by the control requiring staff not to carry cash at work? If the store supplied lockers as part of their staff policy anyway, then the cost might be considered as nil.

The cashing up procedure takes quite a bit of time and therefore has a cost but do any of the trainees think this is time wasted? Presumably not and therefore this

can be taken to be an acceptable cost.

- 3) The cost of operating a control should always be compared to the benefit derived from it. Often the actual cost and the true benefit are difficult to measure and subjective judgement has to be made.

Ask the trainees if they see the slowness of bureaucracy having any relationship to cost? Here the perceived need is to avoid mistakes and therefore excessively complicated internal controls are instigated. This makes the whole process slow and in terms of time spent, very costly. It is often questionable whether the extra effort and time spent is matched by corresponding decrease in errors.

Commercial organisations, including co-operatives, need to balance cost with effectiveness of operation. Controls should not be introduced simply for their own sake, but because there will be a benefit arising from the control which is greater than the cost of operating it.

- 4) Ask the trainees to remind you of the types of control that were discussed in the previous session and write these up on the chalkboard:

- | | |
|----------------------------------|-----------------------|
| - Organisational | - Arithmetical |
| - Segregation of Duties | - Personnel |
| - Physical | - Checks |
| - Authorisational | - Supervision |
| - Acknowledgement of performance | - Managerial analysis |

- 5) Divide the trainees into small groups and hand out the case study "Better Beef - By-Products". Allow the trainees 20 - 30 minutes to study it and prepare their answers.

Ask them to devise one of each type of control which

could be applied to the sale of the manure. They should also decide whether the benefit derived from the control is likely to be greater than the cost of operating it.

There is likely to be a wide variety of suggestions for improvements as there is hardly any system at the moment. There is hardly any system. The trainees should discuss these and decide which ones are reasonable for the situation.

Have any of the trainees worked out the scale of the operation in terms of income and expenditure? This will give an idea of the possible losses that could occur if the system does not provide complete and accurate records and if the society's assets are not secure.

Ask one of the trainees to write on the chalkboard what the income and expenditure involved is. He should get the other trainees to help him and should produce figures similar to those given below.

<u>Income</u>	<u>Average</u>	<u>Price</u>	<u>Total</u>
Bags of manure	100 per month	\$2	\$200
<u>Expenditure</u>	<u>Average</u>	<u>Price</u>	<u>Total</u>
Use of sacks	20 sacks	\$2	\$40
Farmers' time bagging	50 hours	\$1	\$50
Manager's Time	2 hours	\$5	<u>\$10</u>
Anticipated Surplus			\$100

Ask how income might be understated and how "Better Beef's" assets might not be secure.

It is quite possible that "Green Vegetables", don't keep accurate records themselves and sometimes "forget" to pay for all the sacks received. Equally important, they could forget to return all the sacks they receive.

Ask the trainees to recalculate the surplus assuming 25% of bags were not being paid for and that 25% of sacks were not returned.

<u>Income</u>	<u>Average</u>	<u>Price</u>	<u>Total</u>
Bags of manure	100 per month	\$2	\$200
<u>Expenditure</u>			
Use of sacks	27 + 33 sacks*	\$2	\$120
Farmers' time bagging	66 hours	\$1	\$66
Manager's time	2 hours	\$5	\$10
Anticipated Surplus			\$4
Income not received	33 sacks	\$2	\$66

* Sack usage calculation.

If 100 bags of manure are paid for but this only equals 75% of total, then 133 bags are delivered and usage is $133/5$ of 27 sacks.

If 25% of delivered sacks are not returned, then sacks "lost" are $133 \times 25\%$ or 33 sacks.

In this case "Better Beef" are hardly breaking even on the operation and it is essential that they develop some control systems immediately!

The trainees will probably give you a variety of each type of control. You should discuss which category they fall into and the cost/benefit relationship of these controls. An example of each is given below.

- Organisational: A formal contract could be drawn up between the two co-operatives. Costs of this would be management time plus perhaps lawyer's fees.
- Segregation of duties: A committee member could be made responsible for the supply of the manure in the quantities agreed in the contract. Another could be responsible for storing and issuing sacks. The cashier would be responsible for collecting the correct payment. Cost would be a little time and stationery.
- Physical: A small area could be fenced with a locked gate where bags could be stored while waiting for col-

lection. The cost of this might be excessive.

- Authorisational: Bags only to be collected when a detailed delivery note has been prepared and signed by a responsible official of "Better Beef". This again costs only time but can be excessive. You must have experienced the endless delays that can occur when the person responsible has "gone out for a minute".
- Arithmetical: The cashier checks that the extension on the remittance advice is correct. This should be automatic and should not involve any additional cost.
- Personnel: It would be possible to employ someone to run the whole operation. Possible, but expensive!
- Checks: The manager could check that the correct number of bags are ready for collection and that the delivery note is properly completed etc.
- Acknowledgement of performance: The person responsible for supply of manure could be required to write a memo to the manager as soon as the requisite number of bags are ready. Cost is time only.
- Supervision: The farm committee could appoint someone to supervise the operation. This could be the farm manager or an ordinary member. The manager may say he hasn't got time and would have to employ an assistant which would be expensive. The member may expect some form of compensation for his efforts. In either case the committee would have to consider the costs involved.
- Managerial analysis: Presumably the manager prepares a monthly report for the management committee. He could be asked to include a review of the operations of manure sales. As well as providing a control this would give the committee valuable information which they could use to help make policy decisions. Once again the cost of this measure would be managerial time.

Perhaps the simplest control may be to employ one worker to be responsible for the whole operation and to ask "Green Vegetables" to supply their own sacks.

- 6) Conclude the session by asking the trainees if they think it is correct for the auditor of "Better Beef" to be concerned with the manure sales.

The amount of attention given by the auditor should depend on the scale of operation relative to the operations of the co-operative as a whole.

If "Better Beef" has a turnover of \$10,000,000 then the by-product sales are not a material figure. Any error would be unlikely to distort the "True and fair view" of the accounts and little time should be spent on this area by the auditor.

This does not mean he can ignore what is going on and should see it as part of his professional duty to point out that the systems are not adequate and should be reviewed.

If "Better Beef's" surplus for the year is only \$2,000 then the auditor must examine the By-product sales, as any error could materially affect the accounts.

BETTER BEEF - BY-PRODUCTS

You are the auditor of "Better Beef Co-operative Society", a co-operative farm which principally fattens calves for sale at the town abattoir.

To generate additional income the farm sells bagged manure to the nearby horticultural co-operative "Green Vegetables". "Green Vegetables" operates an "organic growth" policy and refuses to use artificial fertiliser. They are therefore happy with their informal arrangement with "Better Beef" which allows them the organic fertiliser they need at a price which is competitive with artificial fertilisers.

The co-operative farm labourers collect and bag the manure when they have time and leave it near the farm gate. Every Thursday the "Green Vegetables" van collects whatever bags are ready and returns the sacks from the previous week. Occasionally "Green Vegetables" complain that there are not enough bags ready for collection to make the trip worthwhile.

Each month a cheque is received from "Green Vegetables" together with a remittance advice stating the number of sacks collected during the month. The cheque is banked by the farm cashier and the remittance advice is filed.

No other records are kept by "Better Beef" as they trust their sister co-operative. The farm manager doesn't want to spend any more of his time on it as he feels the operation is not very important. He estimates he currently spends about half an hour per week on this operation.

From your review of the remittance advices you have seen that on average 100 bags of manure each month are paid for at \$5 each. You have also seen the invoice for the sacks which cost \$1,000 for 500 bags. The manager, who's salary is

\$800.00 per month, says he expects that each sack can be used at least 5 times before it has to be replaced.

You are informed that a farm labourer is paid \$1.00 per hour and on average it takes half an hour to collect and bag one sack of manure.

Assignment

- a) What controls could be introduced to improve the system?
- b) Would these controls cost more to operate than the benefit that is likely to be derived from them?

SESSION 4.4

EVALUATION OF INTERNAL CONTROL

Objective : To enable trainees to recognise the need to evaluate internal controls as part of the audit process.

Time : 1 1/2 to 2 hours.

Material : Case Study a "Controlled Co-operative".
Internal Control Evaluation Sheet.

Session Guide :

- 1) Modern auditing theory puts a lot of emphasis on the evaluation of internal controls.

Ask the trainees why they think this should be the case.

Their answers should all be related to the same theme which is efficiency and economy.

The auditor's time and resources are limited and he should want to make the best possible use of both. By evaluating the control systems he will be able to concentrate his work on areas which appear to be weak. That is, areas where there is a greater possibility of errors occurring.

For example, if he is satisfied that controls over income are strong but the purchasing systems are weak, then he will be able to reduce the level of testing required on income and increase the testing of purchases.

By examining the internal controls the auditor will be able to:

- Ascertain the control system in use.
- Assess the adequacy of the control systems.
- Identify areas of weakness.

By concentrating on areas of weakness he will be able to make the best use of available time in satisfying his objective of reporting on the truth and fairness of accounts.

- 2) Ask the trainees how an incorrect judgement of the dependability and accuracy of controls might affect his opinion of the accounts.

It could mean that he might perform insufficient tests on weak areas which may not reveal the true extent of errors. His opinion of the truth and fairness of the accounts could also be wrong.

The auditor's judgement in this area is crucial. If he is going to rely to some extent on the internal controls of the co-operative to give him assurance about the accuracy of the accounts then he must make sure his assessment is correct.

- 3) It should also be made clear at this point that the existence of good internal control does not rule out the possibility of errors occurring.

Most unintentional errors will be picked up by good control but where someone deliberately sets out to defraud the co-operative, he will take care to avoid the controls which affect the area where he is working.

For this reason an auditor must never ignore an area just because there are good controls. A limited amount of testing will always be required.

In the same manner, weak controls do not mean that there

are errors, only that the possibility of them happening is greater.

- 4) Get the students to tell you how they would proceed to evaluate the internal controls of a co-operative. What steps would they follow.

Usually there are four stages: Study, Documentation, Confirmation and Evaluation.

- Study

Involves the examination of previous audit files, observation of present practice, asking questions and reading manuals.

- Documentation

Auditors should document systems in narrative form. However, trainees should also be aware of "flowcharting". This records the system by using symbols to represent the flow of documents through the organisation, identifying what happens at each stage. Flowcharts are excellent tools if properly drawn up but they are time consuming to prepare and are not easily understood. Only the sophisticated co-operative audit departments would be expected to use them.

Documentation is required for the auditor's own records. It provides him with convenient reference material when he is assessing the system, and will assist him later on when planning audit tests to be performed. It is also required for whoever reviews the work performed and provides evidence that the auditor has been carrying out his work adequately.

- Confirmation

Once the control system has been documented, the auditor should perform a few checks to ensure that he has recorded the systems correctly. (This process, known

as "Walkthrough Testing" is dealt with in greater detail in Session 6.1)

- Evaluation

This can be performed on a judgement basis direct from the documentation. For small and simple systems, judgement evaluation is acceptable providing the auditor has adequate experience to perform the task. For more complex systems a proper structure for evaluation is required.

- 5) One of the methods of evaluating internal controls is to use an evaluation form. A separate form can be prepared for each major system.

Hand out the "Controlled Co-operative" case Study Sheet but do not hand out the Control Evaluation Form yet.

Give the trainees a few minutes to read the narrative and then ask them if they think there are any weaknesses in the control system being operated.

If they do spot any weak areas, discuss with the group whether they all agree that this is the case. Write these up on the chalkboard.

- 6) Now hand out the Internal Control Evaluation Form and ask the trainees to complete the form on the basis of the information given in the narrative on Controlled Co-operative.

These forms are designed so that they are simple to complete and so that areas of possible weakness are clearly seen.

In this case the trainees should realise that a "no" answer indicates a possible weakness. This is therefore an area where the auditor would be expected to test more

thoroughly in order to satisfy himself that no material errors have occurred.

On the completed Evaluation Form given on page 7 there are three questions to which the reply "no" is given. Hopefully the trainees will have the same responses. If not, then take some time to clear up any differences of opinion.

Compare these replies to any areas of weakness that were identified by the students when they read the narrative only.

Ask the trainees to explain what a possible consequence of each weakness could be:

1. A bank reconciliation for the deposit account is not prepared. Interest income could be omitted from the accounts as could abnormal items.
 4. The manager is only given a copy of the bank statement. If the cashier was trying to cover something up then he could alter the original and this would be difficult to see on a photocopy.
 13. Surprise counts are not carried out. If there is a shortage the cashier knows that the manager is only going to count the cash at the end of each quarter. It would be possible for him to borrow funds from outside the co-operative for a day to cover up the shortage. This would be returned to the lender as soon as the count had take place.
- 7) The trainees should be able to suggest tests performed by the auditor in each of the above areas. These tests are to satisfy him that material errors do not exist and could be as follows.

1. A comparison of the ledger balance with a copy of the bank statement. Any differences require investigation.

 4. Comparison of the photocopy attached to the reconciliation. Any differences would be extremely suspicious.

 13. Carrying out a surprise cash count outside the time of audit. If a shortage could be covered up for a couple of days every quarter it could also be covered up for the few days that the auditors are at the co-operative.
- 8) Point out to the trainees that the case study contains the answers to the type of questions that the auditor must ask when studying and documenting the control systems in operation.

Examples of these include:

- How many bank accounts does the co-operative operate?
 - Who write's up the cash books?
 - Who prepares reconciliations and how often?
 - Who checks the reconciliations and how?
 - Who keeps the petty cash?
 - How are cash payments approved?
 - Are surprise cash counts carried out?
- 9) Trainees should be aware that the case study only illustrates some of the controls over financial management in a co-operative. Include a comment that experience in co operatives has shown that cash management is an area which is critical to the operation of co-operatives.

Discuss, using your experience, how cash and bank account frauds have occurred at co-operatives in the country you are working in. Ask what type of controls might have reduced the possibility of these frauds happening.

- 10) There are advantages and disadvantages to Internal Control Evaluation Forms and these should be discussed with the trainees:

Advantages	Disadvantages
Can be standard and pre-printed	Completion can become mechanical without thought
Ensure that important points are not overlooked	Unusual systems may not be covered
Can be completed by less experienced auditors	May not be appropriate in a very small co-operative where control is operated by one or two people (a series of "no" answers may be obtained which does not help direct the auditor)
Suitable for complicated systems	
Draws attention to areas of weakness through "no" answers	
Is easily revised if the co-operative's systems change	
Is easily reviewed by the senior auditor	

- 11) In summarising the session you should reiterate that the co-operative auditor should always be aware of the need to evaluate internal control. This will indicate where he should concentrate his work and will help make best use of his time and resources.

One of the best methods of evaluation is to use Internal Control Evaluation Forms.

The example given is for bank and cash transactions only but can be developed for almost any type of transaction system. Further examples, which can be adapted for co-operative use, can be obtained from any modern audit manual.

INTERNAL CONTROL EVALUATION FORM
BANK AND CASH RECONCILIATIONS

Co-operative Date:

Prepared by: _____

Reviewed by: _____

BANK	YES	NO	N/A
1. Are bank reconciliations prepared for all bank accounts?		*	
2. Are bank reconciliations prepared at least monthly?	*		
3. Are they checked by someone other than the person who operates the cash book?	*		
4. Does the checker see the original bank statements?		*	
5. Does the checker confirm the reconciliation balance with the general ledger?			
6. Is the checker given the pay-in book to review?	*		
7. Is the checker given the cheque book to review?	*		
8. Does the checker follow up items that are more than a month old?	*		
CASH			
9. Are cash reconciliations prepared at least monthly?	*		
10. Are they checked by someone other than the person who operates the petty cash?	*		
11. Does the checker confirm the reconciliation with the ledger?	*		
12. Are unusual items on the cash form followed up?	*		
13. Are surprise cash counts carried out?		*	

CONTROLLED CO-OPERATIVE
Narrative Description of
Bank and Cash Reconciliation System

Bank Accounts

The society operates two bank accounts, a current account and a deposit account. There are few transactions on the deposit account during the year as this is seen to be an investment which earns interest quarterly.

The cashier who writes up the cash book (but is not a cheque signatory) prepares a monthly reconciliation of the current account. This is presented to the manager for his examination and verification. The cashier attaches a photocopy of the latest bank statement to the reconciliation.

The manager keeps the pay-in book and the cheque book in his safe and he sample checks the entries in these against the figures on the reconciliation.

The manager compares the balance with general ledger balance.

The manager queries any item which has not been cleared since the previous reconciliation and items which appear to be unusual.

Petty Cash

The petty cash reconciliation is also prepared by the cashier and presented to the manager on a monthly basis.

This gives an analysis of notes and coins and details any IOU's which may be outstanding. (These generally are travel advances to staff which are approved by the manager, and are cleared within two days of the member of staff returning to the office).

At the end of every quarter the manager verifies the contents of the cash box with the reconciliation.

The manager agrees the balance with general ledger balance.

The manager queries any item which has not been cleared since the previous reconciliation and items which appear to be unusual.

Assignment

Consider if there are any weaknesses in the control system being operated.

INTERNAL CONTROL EVALUATION FORM
BANK AND CASH RECONCILIATIONS

Co-operative Date: _____

Prepared by: _____

Reviewed by: _____

BANK	YES	NO	N/A
1. Are bank reconciliations prepared for all bank accounts?			
2. Are bank reconciliations prepared at least monthly?			
3. Are they checked by someone other than the person who operates the cash book?			
4. Does the checker see the original bank statements?			
5. Does the checker confirm the reconciliation balance with the general ledger?			
6. Is the checker given the pay-in book to review?			
7. Is the checker given the cheque book to review?			
8. Does the checker follow up items that are more than a month old?			
CASH			
9. Are cash reconciliations prepared at least monthly?			
10. Are they checked by someone other than the person who operates the petty cash?			
11. Does the checker confirm the reconciliation with the ledger?			
12. Are unusual items on the cash form followed up?			
13. Are surprise cash counts carried out?			

conduct of an audit

Session 5.1 Audit Planning

Session 5.2 Timing

Session 5.3 Programmes

Session 5.4 Working Papers

Session 5.5 Review

SESSION 5.1

AUDIT PLANNING

Objective: To enable trainees to recognise the importance of and procedure for audit planning.

Time: 1 1/2 to 2 hours.

Material: Case Study "Karak Marketing Co-operative".

Session Guide:

- 1) Ask the trainees what must be done before any audit can commence.

Someone must have an idea of how the job is to be performed, when it is to be carried out and what staff are required.

There has to be some kind of plan. Discuss with the trainees what they think will be gained by spending time on developing an individual audit plan for each audit?

- The audit can be controlled and supervised effectively.
- The methods through which the audit objectives are to be met can be established, e.g. the proportion of compliance testing and substantive tests can be estimated, whether or not attendance at stock taking is required, etc.
- Attention can be drawn to areas of high risk, where the auditor anticipates the possibility of errors existing.
- The requirements of the co-operative - such as the data for the Annual Meeting at which the accounts

are to be presented to the members - can be considered .

- Known material changes in operation or co-operative staff can be considered.
- Work can be carried out effectively by the allocation of a mix of staff with suitable qualifications and experience.
- Work can be carried out efficiently using a minimum of the audit department's limited resources and to time scale requirements.
- Flexibility can be allowed for in the plan, to accommodate unforeseen circumstance such as a senior manager being sick.

2) Discuss with the trainees the purpose, nature and benefits of a "Letter of Engagement". This outlines scope and nature of the work to be undertaken by the auditor and is intended to:

- Define the extent of the auditor's responsibility.
- To minimise misunderstandings between the auditor and the co-operative's management and board.
- To inform and educate the co-operative's management and board about their responsibilities.

A "Letter of Engagement" should be drawn up before any new audit is undertaken. The letter should be reviewed and updated before each audit commences.

3) Hand out the case study "Karak Marketing Co-operative" and ask the trainees to read through the notes about the society. Do not at this stage ask the trainees to attempt to answer the questions but discuss the following points.

- What is the statutory requirement for auditing this co-operative? (This should be the actual statutory requirements of the country you are working in.) Does the relevant act state any special provisions

for this type of co-operative? If so, then this must be included as part of the audit plan.

- What do you know about the background of "Karak Co-operative"?
 - o It began operations before 1983.
 - o It deals mainly with grain marketing, operating on low profit margins.
 - o There is not a high turnover of staff.
 - o The manager seems to make all the decisions.
 - o Stock has caused problems in the past.

- Are there any important figures available?
 - o Galal will have the previous year's accounts to look at but there is also a three-year summary available.

- How is the society doing in relation to other comparable co-operatives? Get the trainees to convert the "Karak" figures into percentages in order that they can be compared.
 - o They will see that "Karak" is an "underperformer" but that no reasons are given to explain this except perhaps for an inactive and static membership.

- Before a plan is drawn up who should Galal contact and what information should he try to get from these people?
 - o The Head of Audit, to see if there are any special instructions or if he is aware of any developments that might not appear in the files. It is essential that the auditor reviews the previous audit file.
 - o Whoever was in charge of the audit last year. A short briefing can often be of help.
 - o The manager of "Karak", who will be able to advise him of any significant changes this year

in operations or staff. He should also be able to provide an estimate of results.

- What are the areas which Galal might consider to have additional audit "risk"?
 - o There have been difficulties with stock. This combined with lower than average margins indicate possible problem areas. The lack of participation by members in the affairs of the society together with the domination of the committee by the manager could also point to weaknesses.

- Are the trainees able to set a level of Materiality based on previous figures? Below what figure would errors not affect the accounts user's interpretation of the accounts? This would have to be altered if there were significant changes in this year's results but an indication could be given to the head of audit. The figures below are given as an example but the actual figures that should be used for discussion with the trainees will depend on local circumstances and practices.
 - o Approximate turnover $\$425,000 \times 0.5\% = \$2,125$
 - o Approximate surplus $\$4,000 \times 5\% = \200

Because of the very low surplus margins it may not be appropriate to base materiality solely on the lower of the two figures. An approximate average of \$1,000 could be reasonable to use as a level of materiality. Errors above this level would have to be altered or the accounts qualified.

- What types of assets, liabilities, income and expenses will a grain marketing co-operative have?

Get the trainees to amplify the following in relation to the local situation.

Stocks	Creditors	Purchase of produce
Machinery	Loans	Sale of produce

for this type of co-operative? If so, then this must be included as part of the audit plan.

- What do you know about the background of "Karak Co-operative"?
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 - o It deals mainly with grain marketing, operating on low profit margins.
 - o There is not a high turnover of staff.
 - o The manager seems to make all the decisions.
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- What types of assets, liabilities, income and expenses will a grain marketing co-operative have?

Get the trainees to amplify the following in relation to the local situation.

Stocks	Creditors	Purchase of produce
Machinery	Loans	Sale of produce

Store	Shares	Overhead costs
Debtors	Reserves	Salaries
Bank and Cash	Deposits	Dividends

- You are told that "Karak" uses the standardised accounts system for marketing co-operatives. Is this likely to ensure that reasonable internal controls are operating?

It should do but this will depend on the degree of compliance at the co-operative. The small number of staff should also be borne in mind as it is more difficult to achieve segregation of duties with small numbers of staff.

It is likely that the degree of compliance regarding stock is poor so extra work will be expected in this area. Discuss what testing might be considered (attendance at stock count would seem to be essential).

- Is there any deadline for the completion of the audit?

Yes, the AGM is to be held on 5 May and the audit report should be ready at least one week before this. That means the field audit work should be complete by the third week in April to allow adequate time for review and to clear up any final points.

- What is the staffing requirement?

The previous year was 21 man-days. However Galal should consider whether extra time will be required to attend the stock count. He must also plan for adequately skilled and experienced staff to be available for the audit.

- What other resources are required?

Transport, stationery, accommodation, allowances etc. Much of this will depend on local circumstances.

- 4) Now ask the trainees to split into small groups to carry out part A. of the case study, bearing in mind all that has just been discussed.

An example is given on the next page but some of what is included may not be applicable to the country you are working in.

M E M O

To : Head of Audit
From : Galal Hassan
Subject : Karak Marketing Co-operative Ltd.
 Audit Planning Notes
Date : 18 February 1991

I have reviewed the previous audit files and after contacting the manager of "Karak", I consider the following points relevant to the planning of this year's audit. I would be grateful for your comments.

- a) The audit of "Karak Marketing Co-operative Ltd." is a statutory requirement under Chapter 12, Section 1 of the Co-operative Societies Act. There are no special requirements for this type of society.
- b) The audit objective is to provide an opinion on whether the financial statements for the year ending 28 February 1991 give a true and fair view.
- c) "Karak" have been operating as a registered society since 1984. No major changes have occurred in its operations, systems or staff during the current year.
- d) The results of "Karak" compare unfavourably with other marketing societies in the province. Gross margins are below average and no significant improvement is anticipated by the society's management this year.
- e) The area of stock has previously caused audit difficulties and more attention should be given to stock and cost of sales this year. I propose that I attend the year-end stock count together with one trainee auditor.
- f) As the 1991 accounts are expected to be in line with

previous years, I propose to use a materiality level of \$1,000 calculated in accordance with the Department's standard policy.

- g) The audit approach will use a combination of compliance and substantive testing based on the Department's audit programme. The level of substantive testing will be determined after evaluating internal controls and compliance with systems. Additional substantive testing will be carried out in the perceived audit risk areas of stock and gross profit. Analytical Review will also be performed.
- h) The AGM is set for 10 May and the audit is planned to be complete for final review by 18 April 1991.
- j) Staffing Requirements (man-days)

	<u>February</u>	<u>April</u>	<u>Total</u>	
Senior Auditor	1	7	8	
Junior Auditor	-	7	7	
Trainee	1	7	8	
	2	21	23	man days

This should provide a suitable mix of abilities and experience. The stock count will be on 28 February and the final audit will commence on 5 April.

- k) I would request that a department vehicle be made available for these dates.
- l) As in previous years the audit team will stay at the "Karak Government Rest House" and I will make the appropriate bookings.
- m) Standard audit stationery will be drawn from the office store.

- 5. Discuss the groups' answers in comparison to the above.

Note that the memo is as far as possible practical and the points are kept short. The details of the testing are not given but the principles to be followed are. The plan must be sufficiently flexible to accommodate unforeseen events and problems.

The completion date allows sufficient time for last minute problems to be cleared up before the deadline date. The staffing requirements details allow the Head of Audit to plan which staff to allocate and for how long. This is essential if the Department is to run efficiently.

The importance of an adequate mix of skills and experience is emphasised.

6. Depending on the time available, either ask the trainees to prepare answers to part B. of the case study, or discuss this generally.

Administrative matters should be concentrated on, as these will have to be resolved before the audit can commence. Amongst others these might include:

- Contacting the "Karak" co-operative management and finalising dates.
- Booking the "Karak Government Rest House".
- Finding out which staff have been allocated and briefing them on the dates of the audit.
- Deciding on stationery requirements (and procuring it)
- Settling transport details, driver, fuel etc.
- Ensuring any imprests or staff advances required are applied for.

Discuss what problems could be caused if each of these were not resolved in time. They would not necessarily affect the result of the audit but would cause inefficiency and would result in additional time or, cost.

KARAK MARKETING CO-OPERATIVE LIMITED

The head of audit has placed Galal Hassan in charge of "Karak Marketing Co-operative". The society's year-end is on 28 February 1991 and the AGM has already been set for 10 May 1991. The auditors last visited this co-operative in April 1990. Before any audit work commences Galal has to prepare an audit plan for submission to and approval by the head of audit.

Having reviewed last year's audit file and the permanent file, Galal has made the following notes:

- The society was registered in 1984 but had been operating as an informal organisation for a number of years previously.
- Turnover comes from the marketing of grains such as rice and maize which carry low-profit margins.
- "Karak" employs 7 staff (Manager, Assistant, Bookkeeper, 2 Storemen and 2 Watchmen) all of whom have been with the co-operative for a number of years.
- Membership has been static at approximately 1000. Members are not active in the running of the co-operative and the committee tends to "rubber stamp" the manager's proposals.
- The accounts system is the standard documented system for marketing co-operatives in the country.
- In 1989 and 1990 there were problems over the quantity and value of stock. Despite these, unqualified reports were issued. The auditors did not attend the stock count.

-	<u>Major Figures (last 3 years)</u>	<u>1990</u>	<u>1989</u>	<u>1988</u>
	Turnover	\$446,000	414,000	420,000
	Gross Profit	\$13,800	12,800	18,500
	Net Profit	\$2,300	1,800	8,500

- Marketing Societies Averages

	<u>Countrywide</u>	<u>1989</u>	<u>1988</u>	<u>1987</u>
	Gross Profit	3.9%	3.1%	5.3%
	Net Profit	2.0%	1.5%	2.4%

- Last year's audit took 3 staff 6 days (each) at the co-operative plus one day at head office. The auditors travelled by department car and stayed at the "Karak Government Resthouse".
- a) Prepare a memo to the head of audit giving a plan covering the following: statutory requirements and audit objective, brief history, areas of risk, staff requirements, other resources required.
- b) State what initial arrangements should be made as soon as possible.

SESSION 5.2

AUDIT TIMING

Objective : To enable trainees determine when audit should be carried out.

Time : 1 to 1 1/2 hours.

Material : Role Briefs "Amalgamated Co-operative Union Limited".

Session Guide :

1. Explain to the trainees that audit work is often split into three sections:
 - An interim audit during the year.
 - A short year-end visit.
 - A final audit after the end of the financial year.

Ask the trainees which types of test should be undertaken at each audit visit.

a) Interim Audit

- Recording or updating the records of the co-operative's systems and internal controls.
- Evaluating the systems to check that they are adequate and to identify any possible weaknesses.
- Carrying out compliance tests.
- Making conclusions regarding the reliability of the systems.
- Carrying out substantive tests on areas of weakness or on unusual or one-off transactions.
- Analytical review of monthly for quarterly) management accounts if available.
- Discussion with management regarding the outcome of tests and trends established by analytical review.

The interim audit should usually be carried out around

the ninth or tenth month of the financial year, i.e. November or December for a February year-end. It will concentrate on systems recording and testing (i.e. walk-through and compliance tests.)

Apart from time considerations, what are the other advantages of carrying out an interim audit?

- Events are relatively recent and are fresh in the minds of the co-operative's staff. Explanations and records are more easily traced.
- It can also have the effect of keeping the co-operative staff on their toes. If they are aware that auditors may appear they are likely to be more diligent in their duties.
- It is also an opportunity to introduce and brief trainee audit staff without the pressures of deadlines.

b. Year-end Attendance

- Observation and testing of stock count.
- Counting of cash balances.
- Verification of (some) fixed assets.
- Observation and testing of cut-off procedures.

It is possible to achieve an exact verification of some assets and liabilities on the last day of the financial year. Where these items represent a material figure on the financial statements or where it is apparent that there could be a system weakness such as cut-off, it is recommended that auditors attend on that day.

c. Final Audit

By implication the final audit must include everything else!

- Follow-up of outstanding points from interim and year-end visits.
- Updating records of systems since interim audit.
- Evaluating any new systems.

- Compliance tests for the period since interim audit.
 - Performing substantive tests on all assets and liabilities and on areas of weakness for income and expenditure items.
 - Performing the analytical review on the year's accounts.
 - Comparing the accounts to the books and records.
 - Performing the audit review.
 - Drawing conclusions regarding adequacy of audit work performed.
 - Discussions with management.
 - Ensuring statutory requirements are met.
 - Preparing and signing the audit report.
2. Ask two trainees to act out the role briefs regarding "Amalgamated C.U. Ltd.".

Explain to the trainee who will be the "senior auditor" that he has to convince the "trainee" that the work plan as described is suitable for "Amalgamated". He should try to include the objectives of the audit and the types of tests that can be carried out at each visit.

The "trainee" should concentrate on the inefficiency of three visits. He should try to question the validity of the explanations given by the audit senior.

3. Ask two more trainees to act out the role brief. See if they are able to bring out any additional points.
4. Discuss the outcome of the role-plays with all the trainees and ensure that the following points are covered.
- a) Objective

To give an opinion on whether the financial statements of "Amalgamated Co-operative Union" give a true and fair view (in accordance with relevant statutes), insufficient time for the accounts and audit report to be presented at the A.G.M.

b) Timing

A deadline of approximately the third week in April has been set. A total of 76 man-days or roughly 4 weeks for 4 people is required to complete the audit work. The Department is very busy during January to March so, if possible, the work should be undertaken outside this period. Apart from staffing pressures which could be got round by postponing other less important work, the co-operative's finance department will require some time to prepare their final accounts. As A.C.U. have strong systems and good staff, it is quite likely that they will prepare schedules and analyses which will be of use to the auditors. If the final audit starts before A.C.U. is ready, time might be wasted. It is therefore unlikely to be efficient to commence the final audit before the end of March.

If the audit requires 4 weeks to complete and it's not possible to start before the end of March then clearly some of the testing should be undertaken during the year or the deadline will not be met.

Stock is one of the major balance sheet items. It is an accepted auditing standard that where stock is a material item the auditors should observe the stock count process. This requires a visit at the end of February.

c) Continuity

While it is a good thing to have continuity of audit staff, a properly organised office which keeps good working papers will be able to switch staff between audit visits. This is especially true of junior staff who tend to work on specific tasks rather than the audit as a whole.

5. The number of audit visits required will depend on the size of the co-operative being audited, deadlines fixed by the client and the work load of the audit department.

For very large audits it may be appropriate to carry out more than one interim audit. For small audits it may be sufficient to make only one audit visit.

Ask the trainees if their department has very busy periods and times when there is not much to do. Do they think this could be improved by splitting the work of any of their audits between interim, year-end and final audit visits?

6. If you have time ask two more trainees to act out the role briefs. Hopefully they will be able to cover most of the points mentioned in this session. For those which they miss out, get the rest of the group to remind them.

AMALGAMATED CO-OPERATIVE UNION LIMITED

The audit department's work plan includes a total of 76 audit man-days for A.C.U. Ltd. The time is allocated as follows:

	<u>December</u>	<u>February</u>	<u>April</u>	<u>Total</u>
Head of Audit	-	-	2	2
Senior Auditor	7	1	12	20
Audit Clerks	14	2	20	36
Trainee	7	1	10	18

	28	4	44	76

A trainee auditor has asked the senior auditor why the audit is split into three parts.

Role Brief 1

You are the senior auditor in charge of the A.C.U. audit which is considered to be one of the largest and most important audits that the department undertakes.

A.C.U. operate good internal controls and generally have competent staff. Stock is one of the largest balance sheet items. The year-end is 28 February and the A.C.U. always hold their A.G.M. in the last week of April.

The Department has to audit a lot of co-operatives with 31st December year-ends and, as a result, there is significant pressure on staff during the months of January to March.

Role Brief 2

You have recently joined the audit department as a trainee

auditor and are surprised that according to the work plan the A.C.U. audit is split over three time periods.

You do not understand why and feel that this must be very costly and inefficient. Surely it would be better to do everything in one go.

How can you test the outcome of transactions before the year end? Won't tests be repeated at each visit? Isn't it likely that there will be staff changes and continuity will be lost?

You have been told that this is one of the department's most prestigious audits but from the work plan it looks as though some of the smallest audits are given preference to A.C.U. Why does the work not start right after the year-end?

SESSION 5.3

AUDIT PROGRAMMES

Objective : To enable trainees to explain the meaning of "audit programme" and their benefits.

Time : 2 1/2 to 3 hours.

Material : "Income Audit Programme"

Session Guide :

- 1) Ask the trainees how they might ensure that all material aspects of the audit of a co-operative were performed. How would they initially decide the work that should be carried out?

One of the simplest ways is to look at the previous year's file and to follow what happened then. Ask what might be wrong with this method.

- Last year's audit may not have been performed to adequate standards and a material item may have been omitted from the audit tests.
- The operations and managements of the co-operative might have changed substantially during the year.
- It might be the first year of operations for the co-operative.

The most common method of ensuring that all material areas are adequately tested is to use a standard audit programme.

- 2) Ask the trainees how they would describe an audit programme. You are likely to receive a wide range of answers but try to guide the trainees towards a description similar to:

- A list of the work which must be considered for per-

formance as part of the audit.

A standard audit programme, must by necessity, be fairly general. If a co-operative has no debtors there is no point in doing any audit tests in this area but the auditor must still consider the situation carefully. He must ask himself why there are no debtors and establish valid answers to his enquiry.

- 3) Apart from the steps and test to be followed what other information should be given on the audit programme?

As the programme is a record of instructions there must be a record of who has carried out the instructions and when. It is easy to put a tick against something as done but it is much more effective to get auditors to sign that they have performed a test. People are unlikely to sign that they have done something when in fact they have not.

There must be a reference to the working papers on which the tests undertaken and the results obtained are recorded.

There should also be evidence that the work undertaken has been reviewed. A trainee's interpretation of the results of an audit test often is not the same as an experienced auditor's.

Finally on the audit programme, there should be space to record whether or not the objectives of the audit have been met. In the case of income the auditor is attempting to gain assurance that the accounting system is adequate, that the records agree with the accounts and that all income has been included.

- 4) Ask the trainees to consider what types of financial transactions and balances are common to almost all types of co-operatives.

- Income
- Expenditure
- Assets
- Liabilities

Any audit programme would therefore have to cover these areas, but the sources of income of a consumer co-operative would be very different from the sources of income of a labour contracting co-operative. The current assets of a credit society would be very different from the current assets of an agricultural marketing society.

Obviously the programme must be sufficiently flexible to allow it to be tailored to suit the type of co-operative that is being audited while at the same time including all major types of transactions.

Although most co-operatives will have more than one source of income, different payment methods and different types of assets and liabilities, it is quite possible to develop audit programmes applicable to each type of co-operative. For example all marketing societies in the country are likely to operate on similar principles and accounting systems. Handicraft societies will differ greatly from credit societies but amongst themselves they will operate along similar lines.

- 5) Hand out the case study "Income Audit Programme" (page 9) and allow the trainees a few minutes to study it.

Ask the trainees what their impression of the usefulness of this programme is. In general discuss whether it could be applied to the following types of co-operative.

- Consumer Co-operative
- Marketing Co-operative
- Labour contracting Co-operative.

Get the trainees to comment on each test. One of the most important points to note is that if the co-operative doesn't record its income through invoices then the audit programme may miss the major part of the society's income. For example, a consumer co-operative will probably not use sales invoices, it may operate on a "cash only" basis. Presumably this could be avoided by substi-

tuting another word such as "source income record" for the word invoice.

Discuss whether or not the setting of a specific number of items to be tested is helpful to the auditor. Although a minimum amount of substantive testing should be carried out, the number of tests should be set in accordance with the effectiveness of internal control systems and the degree of compliance established by performing compliance tests. It should not be set on an "ad-hoc" basis.

6) Explain to the trainees that there are four types of audit tests that must be carried out for the auditor to be able to meet his objectives.

- Walkthrough: checking that the system is correctly recorded.
- Compliance: checking that staff comply with the recorded systems.
- Substantive: a test that obtains direct evidence of the correct treatment of a transaction.
- Analytical Review: a review of relationships between figures contained in the accounts.

These tests are dealt with in detail in Topic 6. These types of tests are the same for any co-operative and therefore should be built into any audit programme.

Ask the trainees if they think each of the four types of tests have been covered by the "Income Audit Programme". Possible Substantive Testing has an Anal ideal Review but there is no mention of Compliance or Walkthrough tests (unless you count the part about authorisation).

It should therefore be apparent to the trainees that the case study "Income Audit Programme" is inadequate and would not be of much help to the auditor. In fact it might be a hindrance as the auditor would not be re-

quired to think about the materiality of each source of income and the necessity to test all material areas.

7) Mentioned above was a labour contracting co-operative. Ask the trainees to consider what type of income this sort of society might have (If there are none of these co-operative's in the country you are working in you may choose another type of society as an example).

- Income from contract.
- Membership fees and levies.
- Grants and other support.
- Sundry income.

Ask the trainees to suggest a list of points which should be included in a programme designed to ensure income is fairly stated.

- Enquire into and record accounting system.
- Conduct walkthrough tests.
- Evaluate system for weaknesses.
- Design and carry out compliance tests to ascertain degree of compliance with recorded system.
- Evaluate compliance tests.
- Design and carry out substantive tests concentrating on areas of weakness or non-compliance.
- Evaluate substantive tests.
- Perform analytical Review.
- Record conclusions regarding tests.
- Perform further tests if considered necessary.

The above list is very general and can apply to any section of the audit. In some audit departments it may be considered that a programme such as this is sufficient but usually auditors would expect more guidance from an audit programme. This is especially the case with regard to specific compliance and substantive tests to be performed.

As for income, the auditor's main worry must be to

ensure that all income is received and recorded. In order to achieve this, additional compliance and substantive tests such as the following could be included.

- Check (sample) that all contracts result in income being recorded.
- Check (sample) that all items are correctly authorised .
- Check (sample) that computations and prices are in agreement with contracts.
- Check (sample) all invoices (or equivalent) are recorded in sales day book (or equivalent).
- Check (sample) credit notes for validity and authorisation.
- Check sequence of invoices (or equivalent) and credit notes.
- Enquire into missing, incorrect or unusual items.

If the programme is to include specific tests to be carried out then there must also be space for reference to be made to individual tests which the senior auditor decides are appropriate only for the society being audited.

- 8) Do not give the trainees the impression that the only advantage to be gained from the use of an audit programme is that there is a set of instructions which should ensure that no material items are omitted from testing. There are a number of other advantages which involve the efficiency of the audit. Ask the students if they can suggest any of these other advantages and discuss them with the group.

- Work should not be duplicated (surprisingly this often happens without an audit programme).
- Junior staff will require a minimum of guidance.
- Work is clearly evidenced and can easily be reviewed.
- Conclusions are more easily arrived at.
- Because staff will get used to a standard approach, efficiency will be encouraged.

- 9) You should also make the trainees aware that there are disadvantages to the rigid use of a standard audit programme.
- Sections of work may be carried out without regard to its content in relation to other areas. Expenditure is often examined separately from liabilities in audit programmes. However, purchase invoices will result in the recording of an expense but should also give rise to a liability. If the link between the two is not considered then the relationship in the accounts may also be overlooked.
 - The work may become mechanical and be applied year after year even though client personnel and systems may have changed. To avoid this the content of the audit programme must be applied by a sufficiently senior member of staff who has the ability to recognise the need for change.
 - If an auditor's suspicions are aroused he should investigate the matter thoroughly until he has reached a satisfactory conclusion. A fixed audit programme can limit such investigations and stifle the initiative of the auditor.
 - If work is performed to a predetermined plan the co-operative staff may become aware of this and design frauds which avoid the areas which they know the auditor will test. In this respect, trainees should be made aware that audit programmes should be confidential to the audit staff and should not be shown to the employees of the co-operative being audited.
 - The auditor may be compelled to spend significant amounts of time on areas which are not material to the accounts.
- 10) A standard audit programme should be designed to cover all important aspects of the area being audited without

being so detailed as to limit the auditor in the use of his initiative. He must be allowed to adapt the programme to suit the individual circumstances of the audit.

Divide the trainees into groups and ask them in approximately 30 minutes to redesign the "Income Audit Programme" in an effort to meet the above conditions. Discuss the programmes proposed by the groups and try to develop a "concensus" programme.

An example is given on the next page but there is no necessity for the programme developed by the trainees to be exactly the same as this one. It is enough that the general principles are followed and that the audit programme is relevant to the local situation.

The compliance tests which have been left blank will depend on the systems in use at the co-operative being audited and the substantive tests will be based on system weaknesses and the results of the compliance tests. Examples of these tests are those given under section 7 of this session.

- 11) So far you have been looking at an Income Audit Programme and you should ask the trainees how they would expect an Expenditure Audit Programme to differ.

In essence there should be very little difference in the structure of the programme, only that you are testing expenditure rather than income.

The factors listed under section 7 of this session are the same in both cases:

- Enquire into and record accounting system
- Conduct walkthrough tests
- Evaluate system for weaknesses
- Design and carry out compliance tests to ascertain degree of compliance with recorded system
- Evaluate compliance tests
- Design and carry out substantive tests concentrating

INCOME AUDIT PROGRAMME

----- Co-operative. Year End -----

	Sample Size	Test Carried Out by	Date	File Ref'	Reviewed By
1					
2					
3					
4					
5					
a.					
b.					
c.					
d.					
e.					
6					
7					
8					
a.					
b.					
c.					
d.					
e.					
9					
10					
11					
12					
13					
14					
	Have proper records been kept ?	YES / NO			
	Are accounts in agreement with books ?	YES / NO			
	Are reported figures true and fair ?	YES / NO			

EXPENDITURE AUDIT PROGRAMME

----- Co-operative. Year End -----

	Sample Size	Test Carried Out by	Date	File Ref'	Reviewed By
1					
2					
3					
4					
5					
a.					
b.					
c.					
d.					
e.					
6					
7					
8					
a.					
b.					
c.					
d.					
e.					
9					
10					
11					
12					
13					
14					
	Conclusions				
	Have proper records been kept ?	YES / NO			
	Are accounts in agreement with books ?	YES / NO			
	Are reported figures true and fair ?	YES / NO			

on areas of weakness or non-compliance

- Evaluate substantive tests
- Perform analytical review
- Record conclusions regarding tests
- Perform further tests if considered necessary.

Discuss the example of the Expenditure Audit Programme given on page 9 of this session. Trainees will notice that the programme is basically the same format as the Income Audit Programme and that it is the specific compliance and substantive tests that change.

- 12) For further examples and variations of Audit Programmes you should advise the trainees to consult auditing text books.

INCOME AUDIT PROGRAMME

-----Co-operative. Year-end-----

	Work performed by
1. Test 25 Invoices for a) Calculations b) Authorisation c) Orders/Contracts d) Posting to ledger e) Prices f) Payment Received	
2. Follow up unusual items	
3. Record authorised signatories	
4. Add Sales Day Book (100%)	
5. Post Sales Day Book to General Ledger (100%)	
6. Add General Ledger and agree to accounts	
7. Review credit notes (100%)	
8. Check new membership entrance fees (100%)	
9. Check Sundry Income (100%)	
10. Compare income with previous years and obtain explanations for variances.	

Comments:.....

.....

.....

SESSION 5.4

WORKING PAPERS

Objective: To enable trainees to recognise the importance of audit working papers and explain their contents.

Time: 2 to 2 1/2 hours.

Material: Case Study "Progressive Wheat Producers' Co-operative".

Session Guide:

- 1) Discuss why the forms and content of working papers are affected by matters such as:
 - The terms of the engagement (e.g. audit or investigation).
 - The nature of the report required (e.g. statutory or otherwise).
 - The nature, size and complexity of the co-operative's business.
 - The nature and condition of the co-operative's records and systems of internal control.

Ask what happens to the working papers after the audit is finished? The auditor should file the working papers securely as they are his property. Quite often these papers are filed away after the audit is complete and not looked at again until perhaps the next audit when they are used for comparison purposes only.

What then is the use of collecting working papers?

It is a generally accepted auditing standard that the auditor should plan, control and record his work. Adequate working papers will ensure that the standard is met by the gathering of audit evidence which is relevant, reliable and sufficient.

2) Ask the trainees why the standard exists, and why adequate working papers must be kept. Include and discuss the following:

a) Audit Evidence for Internal Use.

- Audit staff need to prove to the person who will sign the audit report that they have carried out their work satisfactorily.
- To control the current year's work.
- To let the audit staff see that they have covered all the material areas.
- To ensure that review work has been carried out.
- To allow the formation of consistent conclusions. Each area of audit must not be conducted in isolation and the whole of the audit should contribute more than the sum of its parts.
- To allow the inter-relation between groups of evidence to be considered. For example, if a factory went on to double shift working there would be an increase in wages and probably electricity but there might also be a need to consider increased maintenance costs for machinery being used. Evidence collected in one part of the audit must be related to other sections.
- To provide a starting point for the next year's audit.
- The first stage of planning an audit should be to review what happened last year. The auditor can decide what he thinks is worth repeating and what requires to be altered to produce a better audit.
- To allow for standardisation of work.
- The quality of audit can be compared with other audits
- Junior staff will become familiar with the procedure and should be more efficient in carrying out their work.

b) Audit Evidence for External Use .

- It is possible that the co-operative board or apex organisation may require that certain items of information be confirmed by the auditors. If this has been covered during the audit and properly recorded then the auditor need not undertake any extra work.
- Working papers are proof of work undertaken that may be used as evidence in court. In recent years the trend all over the world has been towards increased litigation and the auditor has not been exempt from this. If a person has sustained a loss because of an act or fraud or because of the negligence of another person then usually the injured party has the right to take court action.
- As an example you could suggest the situation where a co-operative covered up trading losses by falsifying the value of stock. The auditor did not notice this and signed an unqualified report. Because of the losses the co-operative had to go to the bank to raise a loan. The bank granted this on the strength of the accounts and audit report. Subsequently the trading losses became so bad that the co-operative was forced into liquidation and the bank lost its money. In this case the bank could try to prove that the auditors were negligent in their work and could sue for recovery of their loss. The auditor could only prove his innocence by producing working papers which show that he carried out his work adequately.

- 3) Ask the trainees if they think it might be possible to judge the standard of audit performed just by glancing through the complete audit file.

It has been said that an audit is a process of amassing a sufficient quantity of paper to convince anyone that a good job has been done. Could there be any truth in this?

To a certain extent the answer to both questions is "yes"! . An idea of the quality of audit can be gained from a quick look at the working papers. One would look for:

- neatness and consistency;
- referencing;
- system recording;
- compliance and substantive testing;
- clear conclusions;
- evidence of planning and review;
- sufficiency of evidence on which to base an opinion of the accounts.

The last point is where large quantities of paper come in. An audit which requires system documentation, uses internal control questionnaires, audit programmes and the like, involves the collection of papers as evidence. The advent of photocopiers and facsimile machines has been of great help to auditors but has considerably increased the bulk of an average audit file.

- 4) The conduct of any audit will follow much the same overall pattern although the detailed procedures will vary from department to department. In the same manner every audit will involve the collection of working papers but the names given to these papers and the manner of filing will vary.

For this reason there is no right or wrong manner in the collection and filing of working papers. It is sufficient that the information given is understandable, follows a logical pattern and provides adequate support to back up the audit opinion given in the audit report.

To ensure a logical pattern, most working papers are split into two files:

The Permanent File

- Containing:
- Statutory matters (Act and Bye-Laws)
 - Organisation chart

- Senior staff names
- Accounting policies
- Systems records and documents in use
- Brief history
- Comparative performance figures and ratios from previous years
- Notes for future audits.

These are matters of continuing importance which are unlikely to undergo major changes each year. It is important that one of the first actions of the auditor should be to review the permanent file and update it where necessary. This review should also be made at the end of each audit to ensure that the file is ready for the next year.

The Current File

- Containing:
- Matters relevant to the current year's audit
 - An index
 - A copy of the accounts being audited
 - A trial balance
 - A copy of the audit report
 - Details of review having been performed and conclusions reached
 - Schedule of errors found and how these have been dealt with
 - Details of audit time and resources used
 - Report to management of weaknesses and errors together with recommendation for improvement

For each section of the accounts

- A schedule showing how the figure is built up
- An audit programme
- Details of walkthrough tests
- An evaluation of the relevant internal

- control systems
- Details of compliance tests
- Evaluation of compliance
- Details of substantive tests
- Evaluation of substantive tests
- Analytical review
- Documents of external verification (bank certificate etc.)
- Conclusions.

Each section of this will normally contain two components. The first relating to the accounts and the second relating to the audit work performed.

Although generally there will be two working paper files some audit departments may have additional files covering such matters as tax and consultancy work.

- 5) Divide the students into groups of three or four and hand out the case study "Progressive Wheat Producers' Co-operative".

Allow the trainees up to 20 minutes to study the problem and to consider answers to the questions set. Let each group appoint a spokesperson who will present their ideas for discussion by the rest of the trainees.

- 6) For the Progressive Wheat Producers' File, the trainees should notice that the following documents are missing:
 - The accounts being audited
 - Note of relevant statutes
 - Record of systems and documents
 - Summary of errors found
 - Report to management regarding weaknesses (management letter).

Ask the trainees if any of these items are likely to unduly delay Ivan presenting the files for review by the Director.

None of these should be a particular problem. The accounts must be available from the co-operative. Ivan should be able to write the note of relevant statutes in just a few minutes. The systems must be documented somewhere as they have been evaluated by Brono Korochin. By going through the files a schedule of errors could soon be listed and the treatment of each can be evaluated. The report of weaknesses can be prepared after the audit has been finalised.

- 7) Discuss with the trainees the composition of the various types of working papers. You can use some of the examples given elsewhere in this manual as illustrations.
- Client prepared papers (e.g. fixed asset schedule, trial balance, bank reconciliations etc.)
 - Auditor prepared (e.g. notes on committee meetings, computations, results of audit tests, etc.)
 - External evidence (e.g. debtor confirmations, bank confirmation letters etc.)

Get the trainees to give as many examples as they can and decide which category they are likely to belong to.

- 8) You should point out the importance of audit seniors insisting on a high standard of working papers. Good working papers indicate orderly work and clear thinking. One aspect of this should be Referencing. Referencing of the accounts to the trial balance and build-up schedules and referencing of audit work and conclusions to the build-up schedules. This should be done in a manner which makes agreement obvious without the need for further investigation.
- 9) If it is possible, you should try to get hold of a few audit files from the departments where the trainees work. Pass these round and get the trainees to indicate where improvements can be made. This should not be un-

dertaken as a method of criticising the personnel in the department but of showing the trainees that an orderly working paper file is not difficult to achieve and can assist everyone involved in the audit.

PROGRESSIVE WHEAT PRODUCERS' CO-OPERATIVE

Ivan Yeltsov has been asked to finalise the audit of the Progressive Wheat Producer's Co-operative as his colleague has suddenly taken ill. Ivan has been told that the audit is almost complete but the working papers have still to be assembled and referenced before the Director of Audit will review the files and sign the audit report.

When Ivan looks at the files he finds the following documents:

- Evaluation of test results
- List of elected representatives
- Note on staff structure (organisation plan)
- Record of accounting policies
- Extract of minutes and important matters
- Trial balance
- Names of senior management
- Schedules showing build-up of accounts figures
- Evidence of audit work carried out on all sections of the accounts
 - walkthrough tests
 - compliance tests
 - substantive tests
 - analytical review
- Planning notes
- Evaluation of systems
- Conclusions regarding test results
- Statistics of past performance
- Confirmation letters from third parties
 - Bank
 - Lawyer
 - Debtors
- Record of time and resources taken to carry out the audit notes for future audits
- Review working and overall conclusions regarding truth and fairness of accounts

Audit programmes for each section
Draft audit report

Assignment :

- a) How should Ivan categorise the working papers?
- b) Has anything been omitted which is essential for the audit?

SESSION 5.5

AUDIT REVIEW

Objective: To enable trainees to explain the purpose of and need for a detailed audit review, before the audit report is signed.

Time: 1 1/2 to 2 hours.

Material: Tape dialogue (to be recorded in advance).

Session Guide:

- 1) Ask the students to consider what might happen if an audit report is signed which gives a "true and fair" opinion when it later turns out not to be the case.
 - It is likely that somebody (the members, creditors etc.) will suffer financially. The members' bonus might be withheld or the creditors may lose their money.

What might happen to the person who signed the audit report?

- At best his reputation (and that of his department) will be damaged. Accounts users will have little faith in other reports he signs.
- At worst he may find himself in court facing a charge of negligence.

This partly depends on the loss suffered and on the scale of any cover-up by the management. If the auditor should have discovered the problems by meeting normal audit standards but didn't then he is open to a charge of negligence.

- 2) The person who signs the audit report is seldom the person who carries out the detailed audit procedures. Ask

the trainees how the signatory can ensure that the work has been carried out adequately and that he is not exposing himself to risk when signing the report.

The answer is to carry out a detailed review of the working papers to ensure that all work has been completed and that minimum standards have been met.

- 3) Read out the descriptive paragraphs at the beginning of the tape dialogue and then play the tape to the trainees. The first time play the tape right through and afterwards play it again, stopping at the bleeps.

Bleep A

- What do the trainees think of Mr. Kinte's attitude to the c:)-operatives he audits?
- Should opening balance be a problem? Is it likely that the auditors have caused them in the first place by requesting changes to the draft accounts?

Bleep B

- What does Mr. Smith mean by "up to standard", "put on enquiry"- and "audit risk"?
- Why should post balance sheet events be considered?

Bleep C

- What is the result of not leaving enough time for review?
- How much time is likely to be sufficient?
- What can be done about the problem of staff overrunning time schedules?
- What do the trainees think about reviews being carried out at the co-operative?

- 4) Split the trainees into groups and ask them to prepare an Audit Review checklist based on the comments made by Mr. Smith and from their knowledge gained from previous

sessions. Allow about 30 minutes for this exercise. Play the tape dialogue again if requested.

- 5) Allow the trainees to explain their checklists and to compare these with the example given below. Those groups who have not considered the inclusion of audit programmes will require a much longer checklist as the programmes would have answered a number of pertinent questions (see topic 7.1)

Try to compile a consensus checklist which meets the needs of the local situation.

AUDIT REVIEW CHECKLIST (example)

	YES	NO	INITIAL
<u>Internal Control</u>			
- System recorded			
- System evaluated			
- Compliance tested			
- Substantive tests on weaknesses			
- Conclusions drawn are reasonable			
<u>Audit Programmes Completed</u>			
- Income			
- Assets			
- Liabilities			
<u>Schedules</u>			
- Schedule audit queries prepared			
- Schedule audit queries cleared			
- Schedule of errors found prepared			
- Schedule of errors found evaluated			
- Schedule of post balance sheet events			
<u>Accounts</u>			
- Proper record kept			
- Accounts in agreement with books			
- Accounting policies are appropriate			
- Accounting policies are consistent			
- Accounts are consistent with evidence			
- Statutory matters covered			
<u>Audit Report</u>			
- Properly prepared			
- True and fair opinion (if 'no' qualification must be made)			

Audit Reviewed By:.....Date.....

Audit Report Signed By:.....Date.....

Post Audit Items

- Report to management prepared
- Management comments received
- Staff performance reviewed
- Schedule of points for future audits

YES	NO	INITIAL

TAPE DIALOGUE

A visiting Chartered Accountant, Mr. Smith, has been giving a lecture to co-operative auditors on the importance of adequate planning. One of the points he stressed was the need to allow sufficient time for a comprehensive review of the audit papers to be completed before the audit report is signed.

The head of audit, Mr Kinte, wondered if his current practice of a ten-minute discussion with the audit senior followed by a look at the accounts, may not meet an acceptable standard. He decided to ask the visitor more about review techniques.

Klnte: Mr. Smith, I was very interested to hear what you had to say about review techniques and I'd like to know how you approach the task.

Smith: Certainly Mr. Klnte. First of all it's important that some form of review takes place at every stage of the audit. For example, the senior should be constantly monitoring the work of his assistants. The person who has the responsibility of signing the audit report should be kept informed of how the audit is progressing. If there are any problems these must be addressed at the earliest possible moment.

Before the audit commences I check that an adequate plan has been prepared. Even after the interim audit I will have a look at the audit file and have a discussion with the audit senior. However it is what we call the "Post Audit Review" that I consider to be the most important and this is where I concentrate my efforts.

Kinte: I quite agree. I like to let my staff get on with

the work without too much interference and keep most of my input to the final review.

However, sometimes when a file is presented to me for signature I find it difficult to know where to start. What do you begin with?

Smith: There are two basic parts to my review. The review of the audit work performed and the review of the accounts. The modern audit tends to concentrate on the internal controls operating at the organisation. If we can be fairly certain that the systems accurately record all transactions then we have a good basis for believing that the accounts will be true and fair. I start by checking that we have recorded, evaluated and tested the systems of internal control. This, of course, will reveal whether proper accounting record have been kept.

The second stage is to check that the accounts presented are in accordance with the statutes and are in agreement with the books and records. This may sound odd but it's surprising how few accountants are aware of the laws affecting their accounts and how many last minute adjustments are included in the accounts without being entered in the books. I'm sure you've had cases where it has been very difficult to establish the correct opening balances following last minute adjustments the previous year.

Kinte: We often have that problem. I find it very annoying that co-operative managers expect our department to provide them with figures when they can't follow their own workings.

Smith: Well, we are in a service industry after all - we have to try to help the client.

BLEEP A

Smith: Once I've checked the content of the accounts I try to make sure that the test undertaken were relevant and that the conclusions drawn from the results of the tests are consistent with the evidence.

After that I look at the overall performance of the audit. Are the working papers up to standard? Have all the audit programmes been completed? Have all the audit queries been cleared up? Had a review of post balance sheet events been made? - that sort of thing. I specifically look for points that might have put the auditors 'on enquiry' and make sure that these have been properly followed through. The audit risk must be kept to a minimum, don't you agree?

BLEEP B

Kinte: Oh absolutely! What do you do if you're not satisfied with any aspect of the audit performance?

Smith: I send the auditors back to sort it out! That is why you need to allow sufficient time for the review. If there's a deadline to meet there's no point in carrying out the review the day before the accounts have to be signed.

Kinte: We've had a few problems there. My staff continually overrun their allocated time and we struggle with deadlines, but please carry on - what's the next stage?

Smith: I return to the financial statements and look at them as whole - are they consistent within themselves, with the accounting policies and with the audit evidence? If that's OK I can get down to the audit

report. I have to consider if there is anything that indicates that a "true and fair" opinion might not be appropriate. Has the draft report been properly drawn up? Only when I have satisfactory answers to these questions will I be prepared to sign there-
port .

Kinte: Do you think it's necessary to speak to the management before you sign the report?

Smith: Absolutely essential if you're considering a qualification, but even on straight forward reports I try to see the managers. It always helps even if only to show an interest. I like the management to know the face behind the name on the audit report.

Kinte: I like to see the management as well but finding the time is always a problem.

Smith: We think we've found a solution to that one - where possible our partners carry out the audit review on the client's premises. It gives you a feel for what's 'behind the accounts and helps concentrate your mind on the job. It also gets me away from the office telephone which never stops ringing!

BLEEP C

Kinte: I know the problem! So once the report is signed you can put the files away until next year.

Smith: Not quite yet - there's still a bit to do. If we've found any errors or weaknesses which weren't material to the accounts, we report these in writing together with suggested improvements. I have to check this report. Then I like to consider the performance of individual auditors. We need to know who's doing well and who needs a bit of help.

Finally I make sure that a list of points relevant to the next year's audit has been included on the permanent file.

Kinte: You certainly carry out a thorough review. I hope I can remember all the points you've brought up.

Smith: We make it easy for ourselves. We have a review checklist which we use. I can send you a copy when I get back to my office.

Kinte: That would be very helpful, thank you very much.

topic

6

types of audit tests

Session 6.1 Categories of Audit Tests

Session 6.2 Sampling Techniques

Session 6.3 Analytical Review

Session 6.4 Techniques of Testing

Session 6.5 Vouching

SESSION 6.1

CATEGORIES OF AUDIT TESTS

Objective: To enable trainees to distinguish between "Walkthrough, Compliance and Substantive" and apply these in audit tests.

Time: 2 to 2 1/2 hours.

Material: Case Study "Drivers' Co-operative".

Session Guide:

- 1) Begin the session by explaining to the trainees the objective of the session and stress that the performance of these tests is an increasingly important area in the work of the auditor.
- 2) Hand out the case study "Drivers' Co-operative" and allow the trainees about 15 minutes to read it through. Spend some time discussing the functions of the co-operative to ensure that the trainees understand how the system for the purchase and supply of spare parts to members operates.

Ask the trainees "How do the members benefit from the spares service offered by the co-operative.?"

- Presumably the co-operative is able to negotiate discounts with its suppliers as it will be dealing in significantly larger quantities than individuals. As long as this discount is more than 10% then the members will benefit.
- it should also save the drivers time as they will not need to search among suppliers to find who has the spares required and at what price.
- If parts have to be imported the co-operative will

be better able to deal with this whereas an individual would find importation difficult and expensive.

- 3) Part A. of the case study asks "What tests are required to confirm the system for spares is correctly recorded?"

Before answering this question, ask the students what the auditor's objective would be for doing this?

In topic 4 you discussed the importance of Internal Controls in reducing the risk of errors and fraud occurring. For the auditor to evaluate the controls, he must ensure that his understanding on which controls are operating, is correct.

To achieve this he would have to trace documents through the system from initiation to final accounting entry.

Get one of the trainees (with the assistance of the rest of the group) to write on the chalkboard all the documents and books which are part of the system. Establish which is the initiating document and what should the auditor do with it.

- The Supply Request (SR) is the document that starts the process of ordering, and as stated above, this has to be traced through the system.

Get the trainees to list out the steps and tests that the auditor might perform. Point out that the auditor at this stage is only testing to see if his records of the systems in use is correct.

- Pick SR from numerical file
 - Check approved by manager
 - Check receipt for deposit is issued
 - Check Cash Book written up
- Trace SR to PO
 - Check SR 3rd copy) is attached

- Trace PO to SI
 - Check grid is completed
 - Check payment authorised by manager
 - Check PDB is written up
 - Check Creditors Ledger written up with listings
 - Check General Ledger written up
 - Check Payment Voucher authorised by manager and Committee Member

- Trace SI to CI
 - Check authorised by manager
 - Check SDB written up
 - Check Debtors Ledger written up with listings
 - Check General Ledger written up

- Trace CI to payment by member (receipt issued)
 - Check Cash Book written up
 - Check Debtors Ledger written up with listings
 - Check General Ledger written up.

How many Supply Requests do the trainees think should be traced through the system?

if it has been correctly recorded only two or three of these WALKTHROUGH tests will be sufficient. Otherwise the auditor will have to do as many as necessary to satisfy himself that the record of internal control is correctly recorded.

Although the "Walkthrough" test may bring to light inadequacies in the system, definite conclusions cannot be drawn as the sample size is too small.

Once the auditor is happy that he has an accurate record of the control systems in use he can evaluate these systems and consider if they should be adequate to provide

reliable accounts information if consistently and properly applied.

- 4) Do the trainees think the controls are adequate for the auditor to be able to rely on them?

In topic 4 you discussed the use of internal control evaluation questionnaires to help answer this question, but there is no time to go through this process here. Instead, spend a few minutes discussing the strengths and weaknesses of the system. Ask the trainees to suggest where problems could occur.

Points that the trainees should realise are:

- The spares service seems to be a fairly small operation with only a maximum of four people being involved at the co-operative (manager, book-keeper, store keeper and committee member). Strong internal control systems are more difficult to achieve when there are only a few employees.
- Segregation of duties and allocation of responsibility is fairly clearly defined.
- Each operation is reviewed and authorised by someone else, with the exception of the Purchase Order which is prepared by the manager alone.
- There appears to be very little control over receiving and issuing at the store.

From the limited information given it would seem that there are some weaknesses but in general the controls are reasonable. The system should provide reliable information for the accounts as long as the system is used correctly.

- 5) What is the auditor's objective in part "B" of the case study?

- To confirm that the controls are being adhered to not only correctly but also consistently.

These tests are known as COMPLIANCE tests as they are designed to ensure that the staff comply with the recorded systems.

Ask the trainees what they think should be included in the "compliance" tests for Drivers' Co-operative spares system.

They will probably find it difficult to distinguish between "Walkthrough" and "Compliance" tests. This is because the tests are often the same but have a different emphasis.

Get the trainees to repeat the objectives of each test.

- Walkthrough: to ensure the auditor's record of the system is correct.
- Compliance: to ensure that the staff comply with the recorded systems.

The number of items to be tested by compliance tests will depend on the size of the population being tested and has to be sufficiently large to provide reliable audit evidence.

The tests for "Compliance" are almost the same those as for "Walkthrough" although they are not necessarily traced through the system. For example, the auditor may decide to check 5 Supply Requests to Purchase Orders for each month and then test a different 5 Purchase Orders to Supplier's Invoices.

A properly applied Compliance test will involve two stages. Ask if the trainees can identify these stages.

- i) Confirmation that the control has been applied (e.g. completion of the grid on the Supplier's Invoice).
- ii) Repeating the control to ensure that it has actually been carried out (e.g. check the calculations).

This second stage takes the test further than Walk-

through tests which do not require the auditor to repeat the control.

- 6) Hopefully in most cases the auditor should find everything correctly carried out and he can be confident that the controls ensure that the accounting records are correct. However, what should the auditor do if he finds that the control system is not always operated as it should be?

For example, what should the auditor do if he found that 2 Purchase Orders were prepared by the book-keeper and were not authorised by the manager?

- He would need to determine if this constituted a weakness.

Put this to the trainees for their views.

In this case it would be possible for the book-keeper to initiate a false order and arrange for an invoice to be put through the system for which he would later write out a cheque. Very definitely a weakness!

- The auditor would try to establish if the failure of compliance were isolated occasions or if they happened on a regular basis. This could be done by testing a larger sample.

If he found the latter was the case he would need to direct special attention to the area of weakness and perform additional tests to ensure the accounting records are correctly stated.

Ask the trainees if they feel there are any special periods that the auditor should cover in his testing.

- Staff holidays and staff illness.

One of the biggest areas of risk for the auditor who wishes to put reliance on the control systems of a small co-operative is: "Do the controls still operate when staff are absent?".

As with areas of control weakness, the auditor will have to pay special attention to this area and will have to carry out additional testing.

- 7) Part C. of the case study asks "What tests are required to confirm that the figures in the accounts are correct?".

The tests undertaken as compliance tests are part of the process of confirming the figures in the accounts are likely to be correct because of the application of internal controls.

Another type of test is one which seeks direct evidence of the correct treatment of a transaction, asset or liability. This is known as a SUBSTANTIVE test.

Although the second part of compliance testing (reperforming the control) is in itself a substantive test, auditors usually consider any test performed other than as a Walkthrough or compliance test, to be a substantive test.

A certain amount of substantive testing must be undertaken in all audits even where the controls seem excellent as the auditor must obtain some direct evidence of correctness.

In the areas of weakness mentioned above (non-compliance and staff absences) it is substantive testing which the auditor must perform. These tests are seeking direct evidence that the account balance is correct and the test does not rely on the application of internal control.

Split the trainees up into two groups and ask the groups alternately to give examples of substantive tests which could be applied to Drivers's Co-operative's assets and liabilities relating to the spares system.

Applying the idea of substantive testing to income and expenditure transactions may be more difficult for the trainees to understand as the compliance tests seem to have covered this already.

Keeping the same groups as before ask them to give possible substantive test for profit and loss transactions, bearing in mind that substantive testing goes further than compliance tests. Some examples of these would be:

- Verifying a number of transactions with members.
- Checking that all co-operative invoices for the period are recorded in the Sales Day Book by looking at serial numbers (completeness).
- Computation of total gross margin to ensure it equals 10% of cost of sales.
- Adding pages of the cash book, SDB, General Ledger etc.
- Contacting suppliers (and possibly competitors) directly to verify prices).
- Checking a sample of Co-operative Invoices to ensure that the 25% deposit is correctly dealt with.
- Extra testing of Purchase Orders and Payments at times when the manager was absent.
- Testing all payments to suppliers over say, \$10.000.

8) Explain to the trainees that the language and words used to describe the types of tests are not important. However, it is important to understand the purpose of each.

The words "Walkthrough, Compliance and Substantive" are used in the United Kingdom auditing standards and guidelines issued by the professional institutes.

- Walkthrough Test: Testing that the auditor has correctly recorded the system of internal control.
- Compliance Test: Testing that the system is being operated correctly and consistently.

- Substantive Test: Testing that provides direct evidence of the completeness, accuracy and validity of the accounting records.

DRIVERS' CO-OPERATIVE

Drivers's Co-operative is a taxi owners' and drivers' co-operative which has 3 main functions:

- To supply spare parts to members;
- To provide loans for the purchase of vehicles;
- To arrange hire contracts.

The co-operative does not hold any stock of spares but orders them as required by members. The accounts system for this has been recorded by the auditor as follows:

A member completes a pre-numbered Supply Request form in triplicate and presents this to the manager for approval together with a 25% deposit. Once approved, a copy is returned to the member, one is filed in numerical order and the third is used by the manager to prepare a pre-numbered 3-copy Purchase Order form. The original of the Purchase Order goes to the supplier, one copy is filed in numerical order and the third is attached to the Supply Request and is filed under the supplier's name.

When the spares are received, details are entered in the Spares Received Register by the store-keeper. The Supplier's Invoice is given to the book-keeper who prepares a prenumbered 3-copy Co-operative Invoice. The price to the member is calculated as supplier's price plus 10%. The book-keeper stamps the Supplier's Invoice with a grid, completes the items on the grid and enters the details of the Supplier's Invoice in the Purchase Day Book.

Suppliers' Invoice Grid

Purchase Order (No.)		Member (No.)	
Price Checked (initial)		Co-operat. Invoice	
Spares Received (date)		Margin (initial)	
Entered in PDB (date)		Payment O.K. (Mgr)	

The Co-operative Invoice, together with the Supplier's Invoice, is passed to the manager who reviews both and signs the Co-operative Invoice as approval for issue. He also signs the Suppliers Invoice as authorisation for payment. The top copy of the Co-operative Invoice is sent to the member. The second is used to write up the Sales Day Book and then is filed in numerical order. The third copy is filed under the member's name.

As soon as the member pays the balance of his invoice he can present his receipt to the store-keeper and collect his goods from the store. When he collects he sign the Spares Received Register as proof of collection.

The book-keeper writes up the Cash Book, Debtors Ledger and Creditors Ledger weekly and presents a reconciliation of each together with appropriate lists to the manager for his signature of approval. At the end of each month the book-keeper prepares 2-copy Payment Vouchers and cheques for the suppliers. These, together with the relevant invoices, are passed to the manager. The manager and one Committee Member sign the Payment Vouchers and Cheques.

Assignment :

What audit tests are required

- a) To confirm the system for spares is correctly recorded?
- b) To confirm the system for spares is being operated correctly?
- c) To confirm that the figures in accounts are correct?

SESSION 6.2

SAMPLING TECHNIQUES

Objective: To enable trainees to use different methods of selecting a sample for audit testing.

Time: 2 to 3 hours.

Material: Extract of "Drivers' Co-operative Sales Day Book".

Session Guide:

- 1) It is generally accepted in auditing that a complete check of every transaction and every balance of a co-operative is no longer required.

Ask the student the reasons for this.

- Economic: The cost in terms of expensive audit resources would be unacceptable.
- Practical: The users of the accounts do not need 100% accuracy. As long as there are no material or misleading errors they will have adequate information for their purpose.
- Time: Checking every item would take so long that the accounts would be out of date before the audit report could be signed.
- Psychological: The audit staff would get so bored that their work would probably become ineffective. They would miss errors even when looking straight at them.
- Negligible benefit: A complete check would add little to the value of the audit. A few extra errors might be discovered but these could probably be estimated from a sample test anyway.

- 2) It is still necessary to check some items 100%. Can the trainees give examples of these and why they should be subject to greater scrutiny?
- Transactions which are few in numbers but are high in value, such as capital purchases and sales, each of which might be a material amount.
 - Areas where internal control is weak or in the hands of one person only.
 - Unusual items which are not covered by normal systems.
 - Any area where the auditor has been alerted to the possibility of material error or fraud.
 - Items which are specifically mentioned in the statutes governing co-operative audits.
 - Items which the auditor knows he may be asked to explain by the members at an A.G.M. (Committee expenses etc.).
- 3) In most audit areas a 100% test is not necessary and a sample is used.

In audit terminology, examination of a sample provides audit evidence about the whole population (or class) of transaction or balance that is being tested.

From this, ask the trainees what are the objectives of selecting and testing a sample.

- To select a sample that is representative of the group as a whole.
- To obtain relevant and reliable audit evidence on the sample selected.
- To draw conclusions about the whole population from an examination of a part of the population.

- 4) Hand out the sheet "Extract from Sales Day Book" which relates to Drivers' (Taxi) Co-operative which was discussed in the previous session.

Ask them to imagine that they are junior auditors at Drivers' Co-operative and the senior auditor has said he wants audit tests performed on a sample of the co-operative (sales) invoices.

How do they pick the sample to be tested?

Ask for suggestions from the trainees and list these on chalkboard.

- 5) Discuss the stages of audit sampling with the trainees.
- Planning the sample:
 - Why is the test being carried out?
 - What is the population size?
 - What is the definition of error?
 - What is the acceptable error rate?

Put each of these question to the tainees for comments.

You don't know the purpose of the test, but the trainees should remember from the previous session that it could be either walktrough, compliance or substantive. For the purpose of this session, assume it is a compliance test to ensure that every invoice to members results in a (correct) debt being recorded in the debtor's ledger and that every invoice is approved by the manager.

The population to be tested could be all sales invoices or the total value of sales in the year, i.e. 80 invoices or \$24,375.43.

If you are performing compliance test then the definition of error must be non-compliance with the controls established by the system, that is, either a debt is not

recorded, or an invoice is not approved by the manager.

The acceptable error rate must be established before the sample is extracted, otherwise there is great temptation to treat all errors found as acceptable.

As there are two parts to the test being undertaken there will also be two types of acceptable error. You will return to this later on in the session but for the moment you can consider any invoice that does not result in a debt being recorded, as being unacceptable, and the testing would have to be extended.

The lack of the manager's authorisation does not necessarily result in an error being made in the accounts - it only increases the possibility. In this case it might be that if there is one unauthorised invoice which further testing proves to be correctly recorded, then this would be acceptable. However two unauthorised invoices would be unacceptable and would require an increased sample test.

- 6) The second stage of sampling is selecting the sample method to be used. Here we return to the suggestion made by the trainees under (4) above.

Ask if they have any other suggestions after having looked at the planning process and the objectives of the tests.

There are two methods of making a sample selection:

- Judgement Sampling;
- Statistical Sampling.

Each has advantages and disadvantages. Ask the trainees if they can identify some of these.

Judgement Sampling	
Advantages	Disadvantages
Auditor can use his experience and knowledge of areas of risk.	It is unscientific and no quantitative results are obtained.
No time is wasted on playing with statistics. All the time is spent on auditing.	Sample selection can be biased away from areas of risk.

Statistical Sampling	
Advantages	Disadvantages
Can be used by staff who do not have the necessary experience to carry out judgement sampling.	Knowledge of statistics is required by the auditor.
Conclusions can be quantified.	The auditor's special experience is not used to its maximum.
It is efficient in that the sample size will not be too large.	

- 7) Split the trainees into 4 groups. Ask the first group to list a sample containing one invoice from each month.

Ask the second to pick a sample of the eight largest invoices.

Ask the third to pick a sample of any two month's transactions.

Ask the fourth to pick a sample using one of the methods suggested by the trainees under (4) and (6) above or, if this has been covered already, pick a sample of 8 invoices which they feel are representative of all the invoices.

Now give the trainees the following information:

- The audit senior has set the materiality level at 10% of profits which are currently shown in the accounts as \$5,001, i.e. any error above \$500 would be unacceptable as this would be misleading to the accounts users.
- The manager was on leave for two weeks in September and neither invoice 1490 nor 1491 was authorised by the manager. Further investigation showed that the invoices were correctly recorded.
- The book-keeper was on leave for 3 weeks in July, during which time the manager prepared the Members' Invoices. Invoice 1482 omitted customs duty of 15% in error.
- Invoice No.1461 was entered in the debtor's ledger as \$65.80.
- Invoice No.1492 did not include the 10% markup.

Ask each group whether their sample would have included all or any of these items.

Ask what are the implications of each error that exists in the population of members' invoices.

- The first error of compliance has no effect on the accounts as there was an acceptable explanation (the manager was on leave) and because further investigation has shown that no errors of fact have happened.
- The omission of duty on invoice 1482 has resulted in an undercharge to the member of \$151.50.

$$\frac{\$1,010.00 \times 100}{110} = \$918.18 \text{ (actual cost)}$$

110

$$\frac{\$918.18 \times 15}{100} = \$137.72 \text{ (duty payable)}$$

100

$$\frac{\$137.72 \times 110}{100} = \$151.50 \text{ (duty plus 10\% margin)}$$

- Invoice 1461 should have been \$56.80 and so \$9.00 is overstated in the debtors' ledger. If the amount has been correctly stated in the posting of the Sales Day Book to the General Ledger then the Debtor's Ledger balance will not reconcile with the General Ledger balance.
- Invoice 1492 is understated by \$339.00
- The total effect on the accounts is that sales have been understated by \$490.50 and that the Debtor's Ledger will not reconcile with the General Ledger balance.

Ask each group whether their sample would have led them to believe that the Sales Day Book contained material errors.

In the above samples it will have been a matter of luck if they were able to conclude that the members' invoices contained errors but that these errors fell just below the \$500.00 materiality level set by the audit senior.

Ask each group to carry out the following calculations where:

- The number of invoices selected for sampling = S
- The value of invoices selected for sampling = D
- The errors found (in monetary terms) = E
- The sample size, as a proportion of the total population (S or D divided by population) = P
- The total expected error (E divided by P) = Z

a) Sample size		<u>S</u> invoices
Total population		80 invoices
Errors found	\$	<u>E</u>
Sample proportion		P
= Expected total error	\$	<u>Z</u>

b) Sample size	\$	<u>D</u>
Total Population		\$24,375.43
Errors found	\$	<u>E</u>
Sample proportion		P
= Expected total error	\$	<u>Z</u>

For the group who were asked to select the eight largest invoices, their calculation should be as follows:

a) Sample size	<u>8</u>	= 0.10 (P)
Total Population	80	
Errors found	<u>\$490.50</u>	
Sample proportion	0.10	
Expected total error	<u>\$4,905.00</u>	

b) Sample size	<u>\$13,188.30</u>	= 0.54 (P)
Total population	\$24,375.43	
Errors found	<u>\$490.50</u>	
Sample proportion	0.54	
Expected total error	<u>\$908.33</u>	

From the above it can be seen that the evaluation of errors is crucial and where possible it should be made on a value basis as it is value that is being dealt with in the accounts.

If the group who tested the largest 8 invoices, were to believe the evidence of extrapolation from the number of invoices and not the value, then they would be led to believe that something was seriously wrong and that the figure for sales could be 20% lower than it should be.

Even based on the value method, this group would have to extend their testing as the level of error was above

that established earlier on as an acceptable level. However, it would be expected that extended testing (of say another 8 invoices) would bring the calculation of possible error down below the materiality level.

Ask each group to double the size of their sample and to recalculate the possible error in the total of sales invoices as indicated by their revised sample. Compare these results with those obtained previously. There should be a trend developing which indicates the obvious point that the larger the sample size the more likely it is that correct conclusions can be drawn regarding the whole population.

- 8) All the samples in 7) have been selected on a judgement basis and covered approximately between 10% and 20% of the total invoices.

Ask the trainees to consider the situation where the audit senior had decided to use a statistical sample and he considered a 10% sample would be sufficient to give him adequate evidence on which to draw conclusions.

Can the students select samples based on:

- a) 10% of invoices;
- b) 10% of the total sales value.

Each of the above involves establishing a sampling interval.

- a) 10% of 80 Invoices = 8.

Therefore the sampling interval is every eighth invoice.

- b) 10% of \$24,375.43 = \$2,437.54.

Therefore the sampling interval is every 2,437.54 dollars.

Each of the above also involves establishing a starting point which gives every invoice an equal chance of being

selected as part of the sample. A random start number must be chosen.

- a) Random start from 1 to 8 inclusive.
- b) Random start from 1 to 2,437 inclusive.

Random start numbers can be taken from tables or from a computer but these are seldom available to co-operative auditors and usually the best method is to use the serial numbers from a bank note.

Keeping to the groups selected previously, ask two groups to select a sample using method A. and two groups to select a sample using method (b).

As before, ask them to evaluate their results and compare these with information given on actual errors.

How does this compare with the results obtained from the judgemental samples taken earlier?

This should generate further discussion on the use of judgemental sampling versus statistical sampling as applied to the local situation.

Statistical sampling allows inexperienced auditors to select smaller standardised samples but the results need to be reviewed by someone who has a knowledge of statistics, if they are to be meaningful in helping the auditor satisfy his objectives.

Judgemental sampling is a good method for experienced auditors but can lead to larger (less economic) samples and provide vague conclusions which are difficult to defend.

DRIVERS' CO-OPERATIVE
EXTRACT OF SALES DAY BOOK 1991

<u>Date</u>	<u>Invoice Number</u>	<u>Amount \$</u>	<u>Date</u>	<u>Invoice Number</u>	<u>Amount \$</u>
			Brought Forward		9,428.12
Jan 91	1437	45.95	Jun 91	1477	9.74
Jan 91	1438	203.70	Jun 91	1478	1,076.00
Jan 91	1439	69.00	Jun 91	1479	131.50
Jan 91	1440	23.90	Jun 91	1480	10.35
Jan 91	1441	6.20	Jul 91	1481	1,093.00
Jan 91	1442	398.80	Jul 91	1482	1,010.00
Jan 91	1443	81.55	Jul 91	1483	1,734.00
Jan 91	1444	673.35	Jul 91	1484	11.85
Feb 91	1445	23.87	Aug 91	1485	87.70
Feb 91	1446	904.30	Aug 91	1486	58.10
Feb 91	1447	10.75	Aug 91	1487	27.00
Feb 91	1448	99.40	Aug 91	1488	32.50
Feb 91	1449	106.90	Sep 91	1489	69.50
Feb 91	1450	392.60	Sep 91	1490	46.20
Feb 91	1451	49.00	Sep 91	1491	3.70
Mar 91	1452	7.06	Oct 91	1492	3,390.00
Mar 91	1453	23.80	Oct 91	1493	51.60
Mar 91	1454	93.30	Oct 91	1494	42.80
Mar 91	1455	780.00	Oct 91	1495	638.00
Mar 91	1456	1,887.50	Oct 91	1496	49.60
Mar 91	1457	833.80	Nov 91	1497	39.20
Mar 91	1458	43.80	Nov 91	1498	10.00
Mar 91	1459	386.00	Nov 91	1499	220.00
Mar 91	1460	41.70	Nov 91	1500	505.70
Apr 91	1461	56.80	Nov 91	1501	33.90
Apr 91	1462	65.20	Nov 91	1502	600.00
Apr 91	1463	606.05	Nov 91	1503	30.75
Apr 91	1464	57.60	Nov 91	1504	358.00
May 91	1465	80.70	Dec 91	1505	204.75
May 91	1466	6.64	Dec 91	1506	65.00
May 91	1467	73.80	Dec 91	1507	111.90
May 91	1468	8.40	Dec 91	1508	94.00
May 91	1469	32.70	Dec 91	1509	50.90
May 91	1470	14.60	Dec 91	1510	4.62
May 91	1471	22.00	Dec 91	1511	78.00
May 91	1472	107.30	Dec 91	1512	2,093.50
May 91	1473	42.00	Dec 91	1513	30.15
May 91	1474	34.10	Dec 91	1514	14.00
May 91	1475	601.00	Dec 91	1515	44.70
Jun 91	1476	433.00	Dec 91	1516	785.10
		<u>\$9,428.12</u>			<u>\$24,375.43</u>
		=====			=====

SESSION 6.3

ANALYTICAL REVIEW

Objectives : To enable trainees, to interpret relationships and patterns existing between figures in the accounts and relevant external information.

Time : 3 to 4 hours. Plan for a break during the session.

Material : Case Study "Handicraft Co-operative".
Role-play "Manager's Responses".

Session Guide :

- 1) In this session it would help if you can prepare in advance some of the figures used as examples, for presentation on an overhead projector or flip chart. Otherwise you will have to do a lot of writing on the chalkboard.
- 2) The review of the relationship between external information comparison of patterns and trends and the figures contained in the accounts is known as an analytical review.
- 3) Analytical review techniques work just as well for Balance Sheet items as they do for profit and loss account balances.

Ask trainees to suggest relationships which exist between balance sheet accounts and other information. There are many and the few given below are only examples.

- Fixed asset value and depreciation.
- Debtors and sales.
- Creditors and cost of sales.

- Bank loans and interest charges.
- Stock and cost of sales.
- Capital employed and sales.

In practice much of an auditor's analytical review will be based on ratio analysis covering items such as gross profit percentage (covered in the case study), Net profit as a percentage of sales, collection periods and liquidity ratios. Ratio analysis is covered in greater detail in the MATCOM Trainer's Manual "Financial Management". This could be made available to trainees for further study.

4) When will an analytical review be of most use?

This depends on the type of organisation and the information available.

- A long established co-operative whose nature of business varies little from year to year will be ideal for analytic review. Conversely a newly established co-operative operating in a volatile market with an inconsistent sales pattern would be difficult to review in this manner.
- There has to be sufficiently detailed financial information available. As you saw under section 1 of this session, sales and expenses as totals are not enough to show the underlying trends. The more the information can be split down into components (or disaggregated) the more reliable will be the results of the analytical review.
- Relationships have to be as direct as possible (e.g. sales and cost of sales). Wage costs which include overtime, bonuses, incentives, piece work, pension costs, travel allowances, other allowances etc. will be subject to a variety of factors and the influence of each may be difficult to establish.

- External information must be reliable and up to date. There is no point in using an inflation figure which is out of date or has been manipulated and does not reflect the true situation.
- If there are directly comparable organisations (a string of branches), the analytical review should work well.
- An essential requirement for a successful analytical review is the availability of high calibre audit staff to carry out the review. Analytical review requires intelligent, skilled and experienced staff to give effective results.

5) Show the following accounts to the trainees (by overhead projector, flip chart etc.)

	Actual 1991 s	Actual 1990 s	Budget 1991 s
Income	380,700	304,800	330,000
Cost of Sales	<u>261,800</u>	<u>200,200</u>	<u>220,000</u>
Gross profit	118,900	104,600	118,000
Expenses	<u>100,900</u>	<u>89,700</u>	<u>100,500</u>
Net profit	18,000	14,900	17,500
Patronage Bonus	<u>9,000</u>	<u>7,450</u>	<u>8,750</u>
Retained profit	9,000	7,450	8,750

Ask trainees their opinion of the results for 1991. Has the co-operative done well or not?

- Income is well above budget.
- Gross surplus has increased.
- Expenses are almost in line with budget despite increased sales.
- Profit is up.
- Patronage Bonus is maintained at 50% of net profit.

BUT - Gross surplus percentage has fallen.

1990	Actual	52.2%.
1991	Budget	53.6%.
1991	Actual	45.4%.

At first sight the co-operative appears to have had a successful year but there is insufficient information to make definite conclusions.

- 6) Hand out the case study "Handicraft Co-operative".

Trainees will notice that the figures are the same as those given above in section (5) but a more detail, 2d breakdown is given.

Divide the trainees into small working groups. Allow them up to 45 minutes to study the accounts and to draw up answers to the questions set.

- 7) Ask one of the groups to present their answers to part and discuss these with the rest of the trainee:

Ensure that the following points are brought out.

Sales

- The 25% increase in tourists has resulted in a corresponding increase in sales. This is in line with the other shops and the recorded figure appears reasonable.

Cost of Sales

- The percentage increase in cost of sales should be directly related to the sales increase if the margin is maintained at 50% the gross surplus percentage has fallen significantly.

	Actual 1991 \$	Actual 1990 \$	Budget 1991 \$
Gross profit	113,700	99,500	110,000
Cost of Sales	261,800	200,200	220,000
	43.4%	49.7%	50.0%

While sales have risen by 25% Cost of Sales have increased by 30% and the co-operative's gross margin in percentage terms has fallen as a result.

This is a significant change and, Conchita, the auditor, must obtain and verify a satisfactory explanation for the change.

Sundry Income

- It looks as if the rent freeze contained in the budget prevented "Handicraft" from increasing their sub-tenant's rent. However this must be confirmed by Conchita

Sales Tax

- The season trade pattern is an important factor here and trainees should be able to prepare the following calculation, bearing in mind that two-third of sales are achieved in the first half of the year and that tax increased from 8% to 10% in July.

	Jan-Jun (2/3)	Jul-Dec (1/3)	Total \$
Sales	220,333(108%)	125,167(110%)	75,500
Tax	<u>18,543(8%)</u>	<u>11,378(10%)</u>	<u>29,921</u>
Net Sales	231,790(100%)	113,788(100%)	345,578

As the calculation figure is very close to the recorded figure, Conchita can gain assurance that there is unlikely to be a material error contained in this area of the accounts.

The inclusion of sales tax in the sales figure might have affected the calculation relating to gross profit margins. Thus the sales tax figure is affected by the budget as well in gross terms by the increase in trade. To ensure that the initial conclusion regarding the fall in margin is correct another calculation should be made.

	Actual 1990 \$	Actual 1989 \$	Budget 1990 \$
Sales	375,500	299,700	330,000
Sales Tax	<u>29,900</u>	<u>22,200</u>	<u>24,500</u>
Net sales	345,600	277,500	305,500
Cost of sales	<u>261,800</u>	<u>200,200</u>	<u>220,000</u>
Gross profit	<u>83,800</u>	<u>77,500</u>	<u>85,500</u>
Gross profit %	32.0%	38.7%	38.8%

This provides further proof that the gross profit margin has fallen at a time when it would not have been expected to and adequate reasons for this fall must be sought.

Wages and Salaries

- The anticipated increase would be 5% (half of 10% increase in July).

1990 Wages	=	\$22,400 + 5%	=	\$23,520
1990 Actual				<u>25,800</u>
Unexplained increase				\$2,280

Wages are therefore higher than would be expected and further investigation is required.

Utilities

- The anticipated increase would be 7.5% (half of 15% increase in July).

1990 Actual	=	\$11,100 + 7.5%	=	\$11,930
1990 Actual				<u>11,900</u>
Variance				\$30

This difference is not material and Conchita will consider the reported Utilities cost as reasonable.

Fuel and Repairs

- It is difficult to make accurate comparison with these figures as they contain 2 components, fuel (30% increase in June) and repairs (level of inflation 15%). Conchita would need to know the split of costs between the categories but in general a figure of 15% increase would give an indication.

1990 actual = \$4,900 + 15% = \$5,635

1990 actual	5,500
	<hr/>
Variance	\$135

This should be sufficient to give Conchita confidence that there are no material errors in the reported figures for fuel and repairs.

Depreciation

- There is no comparison between the figures for 1990 and 1991. Also the 1991 actual figure bears no relation to the one budgeted.

Can the trainees indentify possible causes for this?

- An error;
- Disposal of vehicles. (Unlikely, since fuel and repair costs are in line with the expected);
- Vehicles already fully depreciated. (Unlikely, since the budget should have reflected this);
- A revaluation of vehicles;
- A change in depreciation policy.

Obviously Conchita will have to investigate this item thoroughly.

Rent

- No increase due to rent freeze which is confirmed by the Sundry income figure.

Stationery

- Expected increase (inflation) 15%.

1990 actual = \$2,900 + 15% = \$3,335

1990 actual	<u>4,600</u>
Variance	\$1,265

Stationery costs are nearly 40% higher than might be expected and this will require explanation.

Committee Allowances

- There is no information given which can explain the drop in cost. Investigation is required.

Advertising

- The budget figure of \$15,000 indicates a change of policy (presumably to achieve the budget 10% increase in sales). It seems that the new policy has, for some reason, not been implemented. Further investigation is required.

Sundry Costs

- Expected increase (inflation) 15%.

1990 actual = \$1,200 + 15% = \$1,380

1990 actual	<u>1,400</u>
Variance	\$ 20

The variation cannot be considered as material and therefore the reported figure is reasonable.

Patronage Bonus

- This remains at 50% of net surplus but in comparison to cost of sales (presumably the basis for paying the bonus) it has fallen.

	Actual 1991 \$	Actual 1990 \$	Budget 1991 \$
Bonus	9,000	7,450	8,750
Cost of Sales	<u>261,800</u>	<u>200,200</u>	<u>220,000</u>
	3.4%	3.7%	4.0%

The percentage fall is a reflection of the drop in gross profit percentage.

- 8) Only a few of the costs have been confirmed as reasonable (Utilities, Fuel and Repairs, Rent and Sundries). It might appear to the trainees that the review of the accounts (which, if done properly, can take quite a time), has not been very helpful from the auditor's point of view.

Before Conchita decides how to use the information she has gained she should discuss her findings with the management of the co-operative. Most probably there are perfectly acceptable reasons for the variations.

Ask two trainees to assume the roles of the Manager and Conchita in the role-play "Manager's Responses".

The trainees should discuss whether or not they think the explanations are reasonable and how these can be confirmed.

- a) The trainees should try to calculate the possible effects of the discount scheme.

	Jan-Mar	Apr-Jun	Jul-Dec	Total	Actual
sales	125,000	125,000	125,000	375,000	375,500
Cost	<u>83,333</u>	<u>92,600*</u>	<u>83,333</u>	<u>259,266</u>	<u>261,800</u>
Profit	<u>41,667</u>	<u>32,400</u>	<u>41,667</u>	<u>116,324</u>	<u>113,700</u>
Profit %	50.0%	35.0%	50.0%	44.9%	43.4%

*Cost for the 2nd quarter is calculated as:

- Sales 125,000 = 100% less 10% discount
- Value 138,900 = Sales x 100/90
- Cost 92,600 = Value x 2/3 (50% mark-up)

The estimated Gross Profit percentage is still higher than the actual recorded figure. It would seem unlikely that all sales were fully discounted and therefore Conchita should be aware that the explanation is not satisfactory. She should also bear in mind that the other comparable co-operatives were able to maintain a 50% mark-up, so why did "Handicraft" have to reduce theirs?

Can the trainees suggest what additional information would help here? If monthly accounts were available Conchita would be able to pinpoint the months where the margin was below expectation and could concentrate on these.

- b) Again a calculation would help confirm this statement.

For this purpose you should use assumption appropriate to local conditions and fit this into those used below.

Basic week	40 hours per week
Overtime required	3 hours per week
Overtime rate	Time and a half
Paid in theory	44.5 hours for 6 months

1990 Wages	$\$22,400 \times \frac{44.5}{40.0} \times \frac{6}{12} + \frac{(22,400 \times 110\%)}{2}$
Theoretical payment	\$24,780
1990 actual	<u>25,800</u>
	\$1,020

There is still a difference which should be followed up by examining payroll numbers and rates.

- c) Conchita would have to check the relevance of the new policy and its calculation. She would also have to

ensure that the necessary approval has been given by the committee and that a note is included in the final accounts reflecting the change.

- d) This seems to be good business but as it is a material figure (approximately \$3,000) the transaction must be checked. Conchita might suggest that this stationery be included as an item of stock and its value be removed from the Profit and Loss Accounts and be included in the Balance Sheet.
- e) This could be checked by reviewing the Minute Book.
- f) A review of the minutes and checks of the relevant vouchers is required to confirm this.
- g) Whether or not the member's bonus is cut is not something for Conchita to concern herself with unless she feels the accounts do not show a true and fair view. However, the members are unlikely to be happy about the cut and may ask the auditor for her comments at the A.G.M. She should be prepared for this possibility and should be able to say why it has happened.

Assuming that the manager's explanations for items (c) to (f) can be confirmed, then Conchita will have to concentrate her resting on establishing the reasons for the fall in Gross Profit Margin and the unexplained increase in wage costs.

Some substantive testing will still be required for the other items but the risk of these containing a material error is greatly reduced and therefore the amount of testing can also be reduced. A few hours spent on a thorough analytical review by Conchita may save her many hours of audit testing and greatly increase the efficiency on the audit.

Briefly discuss the trainees, answers to part B of the case study. Do these highlight the problem areas? Have

reasonable tests been suggested to reveal the reasons for the variations from the expected figures?

9) What are the advantages of analytical review?

- It is an extremely efficient audit technique;
- It is cost effective;
- It can highlight possible problem areas before the main testing of the audit has begun;
- It can give senior staff confidence that juniors have not missed any material errors.

10) What are possible disadvantages of analytical review?

- If the staff carrying out the review are not competent then they may misread relationships between figures.
- Any unexpected variance must be investigated until a satisfactory explanation is received. If there are a lot of unexpected variances then this could cause a significant extension of audit testing.

HANDICRAFT CO-OPERATIVE

Handicraft Co-operative operates in the tourist district of the country and sells locally manufactured artifacts to tourists. They compete with two other artisanal co-operatives with shops in the area.

Conchita is in charge of the audit of Handicraft Co-operative and is of a specialist in this area. She has already carried out the 1990 audit of the other two artisanal co-operatives and has performed the audit of Handicraft for the past two years.

On arrival at Handicraft she was given a draft set of accounts for the year ending 31 December 1991 and a copy of the 1991 budget. From these and by reference to last year's accounts she has drawn up a schedule in order to compare the figures reported in the profit and loss account. (see next page).

From Conchita's experience of Handicraft and from her knowledge gained at the other co-operatives she is aware of the following factors:

- The tourist trade is seasonal with two-third of sales being made in the first six months of the year.
- Tourist trade for the country was up by 25% during 1991 and sales at the other co-operatives reflect this increase precisely.
- Gross profit margins at the other shops have been maintained at close to 50% of cost.
- Inflation in the country is running at 15% per annum.
- The government's budget (effective 1 July 1991) contained the following measures:
 - ° Wage rise of 10% for all (wages are strictly controlled by the Government and the last rise was in 1989)

- Sales Tax increased from 8% to 10%
 - Petrol price increased by 30%
 - Telephone, electricity and water charges increased by 15%
 - All rents frozen for 1 year;
-
- Handicraft's budget for 1991 was prepared on the basis of 5% inflation and 10% increase in sales;
 - Handicraft (in common with the other societies) set their sales price (including tax) at cost plus 50%;
 - Sundry income comes mainly from subletting part of the shop.

HANDICRAFT CO-OPERATIVE (continued)
Schedule of Profit and Loss Accounts

<u>Income</u>	Actual 1991 \$	Actual 1990 \$	Budget 1991 \$
Sales (incl. tax)	375,500	299,700	330,000
Cost of sales	261,800	200,200	220,000
	<hr/>	<hr/>	<hr/>
Gross profit	113,700	99,500	110,000
Sundry income	5,200	5,100	8,000
	<hr/>	<hr/>	<hr/>
Total income	118,900 =====	104,600 =====	118,000 =====
<u>Expenditure</u>			
Sales tax	29,900	22,200	24,500
Wages and salaries	25,800	22,400	23,500
Utilities	11,900	11,100	11,600
Fuel and repairs	5,500	4,900	5,100
Depreciation	500	3,000	3,000
Rent	10,000	10,000	10,500
Stationery	4,600	2,900	3,000
Committee allowances	1,900	2,200	3,000
Advertising	9,400	9,800	15,000
Sundry	1,400	1,200	1,300
	<hr/>	<hr/>	<hr/>
Total expenditure	100,900 =====	89,700 =====	100,500 =====
Net profit	18,000	14,900	17,500
Patronage bonus	9,000	7,450	8,750
	<hr/>	<hr/>	<hr/>
Retained profit	\$9,000 =====	\$7,450 =====	\$8,750 =====

Assignment:

- a) From the information given, what are the relationships which Conchita should examine when performing an analytical review of Handicraft's accounts?
- b) How can she use this information when setting the audit tests to be performed?

HANDICRAFT CO-OPERATIVE - MANAGER'S RESPONSES

Interview of Manager by Auditor (Conchita)

- a) Conchita: I see your turnover has increased in line with the increased tourist trade, but can you tell me why the gross profit margin has fallen during 1991?

Manager: It wasn't easy achieving the increase in sales. Competition was fierce. In the second quarter we let staff offer a 10% discount on all prices if they thought it would secure a sale. This allowed us to keep sales at the same level as January to March.

- b) Conchita: Why are wages and salary costs up by 15% this year?

Manager: Apart from the pay rise, we kept the shop open for an extra 3 hours each week during January to June. We had to pay overtime for this.

- c) Conchita: Why was the depreciation charge so low this year?

Manager: in October the committee agreed to revalue the assets and review the depreciation policy. The new policy reflects the vehicles' useful lives.

- d) Conchita: Stationery costs were higher than budgeted - why?

Manager: We received a good offer from our supplier and we took advantage of this. In December we bought enough stationery to last us for the next 12 months.

- e) Conchita: Why did committee allowance fall this year?

Manager: A bit of luck! The member from Hagiston - you know that village at the other end of the province - resigned in January. He was replaced by someone local. This saved us a lot in travel expenses and hotel bills every time we had a committee meeting.

f) Conchita: Did your advertising policy change this year?

Manager: It was planned to. We were going to run a radio campaign. When we saw the increased sales figures in the first quarter, we dropped it.

g) Conchita: How do you think the members will respond to the cut in their patronage bonus?

Manager: It's not a cut! We have maintained the 50% distribution policy. I think the members will appreciate the year's results, especially when they see how well we have controlled our costs during this period of inflation.

SESSION 6.4

TECHNIQUES OF AUDIT TESTING

Objective : To enable trainees to identify and apply the four techniques of audit testing.

Time : 1 to 1 1/2 hours.

Material : Case Study "Thrifty Credit Society".

Session Guide :

- 1) During previous sessions under this topic of audit tests you have been looking at specific types of tests that an auditor would carry out - Walkthrough, Compliance and Substantive tests. In this session you will discuss the techniques required to carry out any type of audit test. What is it the auditor actually has to do to satisfy his objectives?

This is intended to be a summary session of audit testing which should ensure that not only can the trainees identify each type of test but they will also be able to apply the necessary techniques to complete the tests successfully.

- 2) Hand out the case study "Thrifty Credit Society" and allow the trainees a few minutes to read the questions.

The first question to ask is what type of test is Moses being asked to carry out. Is it Walkthrough, Compliance, Substantive or Analytical review? Once this has been established the trainees should be able to state the objectives of the test.

- a) This is a simple substantive test where the auditor is trying to verify the existence and value of an asset. Ask the students to explain the procedure that

would be involved. This will include inspecting the safe, observing serial numbers and condition, and computation of depreciation charges.

- b) A compliance test checks that the system is being operated properly. The procedure will be to ensure that the laid down procedure is followed correctly. If the system is not being followed then some internal controls are being avoided and there could be weaknesses which could lead to errors.
 - c) An analytical review helps to identify material differences and then establish valid reasons for these differences. The test will be one of computation and enquiry. Moses may break down the figures into months and compare these. He would have to enquire about movement of employees and any salary increases. He will only have satisfied the objectives of the test once he has established valid reasons for any material difference from the previous year.
 - d) This is likely to be a Walkthrough test which is to ensure that the auditor's record of the system is correct. The auditor would study the system as recorded and follow through the entries for the two members. He would not necessarily check the computations but would observe and inspect the relevant entries.
- 3) Ask the trainees to give examples of tests that they might carry out at a credit society and discuss which type of test category these come under and the procedure required to carry out each test. List some of these examples on the chalkboard.
- 4) Point out to the trainees that each of the above tests involve a combination of techniques which the auditor must use. The most obvious one is inspection. Moses has to look at the safe to make sure it is there (and not another safe) and that it is in reasonable condition. He must also undertake some computation to ensure that the depreciated value is fairly stated.

Question (b) involves enquiry and observation. Moses has to find out what is supposed to be happening and then check whether or not it is. Question (c) will be mainly a case of computation followed up by asking questions about the figures. The final question is similar to question (b) where Moses has to find out what is supposed to happen and check whether or not the auditor's record is correct.

From this the trainees should see that techniques of audit testing fall into four categories:

- o Inspection - Examining records, documents or tangible assets.
- o Observation - Looking at an operation or procedure being performed by someone else to determine the manner of its performance.
- o Enquiry - Seeking information from knowledgeable people either inside or outside the co-operative.
- o Computation - Checking the arithmetical accuracy of accounting records or performing independent calculations.

In most cases each audit test will involve a combination of these factors but the type of test being undertaken will determine which techniques the auditor will use to meet his objectives.

- 5) Go back to the examples noted on the chalkboard under section (3) above. Ask the trainees to identify again which type of audit test each falls under and the techniques that are required for each test.

Hopefully you will be able to establish that substantive tests will almost always involve observation. Analytical Review will require computation. Other techniques requi-

red will depend on the specific test being performed but where there is any reason for doubt, enquiry will always be the auditor's main technique. The auditor must continue his enquiries until he has received a satisfactory answer.

THRIFTY CREDIT SOCIETY

Moses is a trainee auditor with the Co-operative Department. His audit senior has asked him to carry out the following audit.

- a) Check the existence and depreciated value of the office safe.
- b) Be in attendance and observe the reimbursement of savings to a member.
- c) Compare total salaries with the previous year and analyse any material differences.
- d) Pick up two members' balances at random and follow through the process of paying interest on their accounts.

For each type of test what is the objective of the test and what is the procedure Moses should follow?

SESSION 6.5

VOUCHING

Objective: To enable trainees to understand the objectives of vouching and to describe the method of approach.

Time: 1/2 to 2 hours.

Material: Case Study "Hoe Ples Cooperative".

Session Guide:

- 1) Ask the trainees if they would expect very small co-operatives to have weak or strong internal control systems.

In small co-operatives internal control systems tend to be weak or non-existent. Where there are few staff it is difficult to achieve division of responsibilities or segregation of duties. Everyone has to do a bit of everything.

In a situation like this, one of the most important items determining the accuracy of the accounts will be the ability and honesty of management.

In a very small audit there are likely to be relatively few transactions. This allows the auditor a greater contact with the details of each transaction. Where this is the case substantive testing will take on greater importance in the process of gathering audit evidence.

- 2) The most common type of substantive test is known as "vouching". Ask the trainees what they understand by the word vouching.

Their answer should be close to:

- Checking that there is documentary evidence which supports the entry in the books of account.

It is important to recognise that vouching considers one entry at a time and not the operations of the co-operative as a whole.

3) In the previous session you saw that the techniques of auditing include four categories of testing:

- Inspection
- Observation
- Enquiry
- Computation

Are all of these appropriate to vouching?

- Inspection - Yes: Examining records and documents;
- Observation - No: The transaction has already taken place it is not possible to watch it. Observation is normally applicable to compliance testing;
- Enquiry - Yes: You can ask people what the transaction was about;
- Computation - Yes: Checking the arithmetical accuracy of the transaction.

4) Hand out the case study "Hoe Ples Co-operative" and ask the trainees to write down in 15 minutes everything they can find wrong with the transaction. There are a lot of errors!

- For example - The stationery used is inadequate;
- No one has signed the delivery note to confirm that the goods were received as described;
 - There are calculation errors on the invoice.

Discuss the various errors and weaknesses with the group and try to compile a comprehensive list on the chalkboard.

- 5) Try to extract from the trainees the method by which the auditor should vouch a transaction. This should include ensuring that:
 - a) The transaction has something to do with the aims and operations of the society.
 - b) All stages of the transaction should be properly documented.
 - c) All stages of the transaction should be properly authorised by the management.
 - d) The transaction is correctly described by the ledger entry and therefore will be correctly incorporated in the year-end accounts.

- 6) Relate the above to the Hoe Ples Co-operative.
 - a) Is it likely that an insurance co-operative which has no fixed assets should buy spare parts for a Mercedes?
 - b) Documentation exists but is totally inadequate.
 - c) Authorisation has not been adequate at any stage of the transaction.
 - d) The transaction is not correctly described. You can't even be sure that the invoice relates to the order or delivery. It may not be an authentic invoice. The cash payment may not have gone to the right person.

The tests relating to inspection and computation have now been carried out and have to be followed by enquiry. Someone at Hoe Ples Co-operative has a lot of explaining to do!

7. In a co-operative such as Hoe Ples there is little point in undertaking compliance testing or evaluation of controls as this would be a waste of time.

The audit should instead rely on substantive testing and

vouching in particular, in order to gather sufficient audit evidence to give an opinion on the accounts.

HOE PLES CO-OPERATIVE

Odit Joonyer has been asked to vouch a ledger entry regarding a cash payment of \$420.00 made by Hoe Ples Co-operative on 10th October 1991. Hoe Ples is an insurance co-operative which operates out of hired offices, has no fixed assets apart from office furniture and employs only three staff - Fred the manager, Floella his deputy and Gladys the accounts clerk.

Gladys has produced the following documents which she says relate to the payment.

HOE PLES CO-OPERATIVE

Hoe Please supply as discussed
4 tyres for Mercedes 190 E
tubes to match.

Fred, 19/9/90

With the compliments of
the manager

DELIVERY NOTE

To H.P. Co-op
1 set 175 x 14 covers
complete with tubes

Delivered by Joe Bloggs
20 Sept '90

~~GENUINE SPARE PARTS LTD.~~
JOE'S SUPPLIES
Invoice No. 705

To: H.P. Co-operative Date: 7 Oct '90

Qty	Item	Price	\$
5	Grade 2	50.00	200.00
4	Inners	10.00	40.00
		Total \$	420.00

Gladys - Pls pay
cash A.S.A.P!

Fred!

How many possible weaknesses and errors should Odit Jooner report regarding this transaction?

verification

- Session 7.1 Verification of Assets
- Session 7.2 Verification of Fixed Assets
- Session 7.3 Verification of Current Assets—Stock
- Session 7.4 Verification of Other Current Assets
- Session 7.5 Verification of Liabilities

SESSION 7.1

VERIFICATION OF ASSETS

Objective: To enable the trainees to recognise the essentials of verification of assets and the procedures involved and to apply these to the verify fixed assets.

Time: 2 to 2 1/2 hours.

Material: Balance Sheet - "Nationwide Co-operative Limited Asset Register - Nationwide Co-operative Limited".

Session Guide:

1) Much of co-operative audit time will be taken up with the verification of items appearing in the balance sheet. These items can be split into two main categories which the trainees should already be aware of:

- Assets and Liabilities.

Just to make sure everyone is clear about the meaning of these, ask the trainees if they can give a definition of each. These should approximate to:

- o Assets: Property or resources that the co-operative owns and is of value to it.
- o Liability: Obligations that are owed by the co-operative and which can be ascertained.

2) In this session you will concentrate on the verification of fixed assets but there are 6 overall essentials of verification of any type of assets and these should be identified first.

Ask the trainees what the auditor should look for to establish whether or not a figure given in the accounts for buildings is true.

- He must find out if the buildings really exist.
- He must confirm the cost of the buildings.
- He must check that the co-operative actually owns the buildings.

He must ensure that all buildings have been included that the accounts are complete and that nothing has been omitted.

- 3) Two other essentials must be included to ensure that the criteria of fairness is met and these, as would be expected when discussing fairness, are of a more subjective nature.

If a building is in a poor state of repair its cost may have little relation to what it is actually worth to the co-operative. Including the actual (historic) cost of the building in the accounts would be true but would not be fair. What should the auditor do in this case?

He should ensure that the current value is disclosed which may require reference to a qualified valuer).

Get the trainees to consider the situation where a co-operative's goods store was overflowing. During the rainy season the management erected a tarpaulin over pallets and scaffold poles to protect the goods. This was sited at the side of the store and cost \$2,000. Would the co-operative be correct to include this in the total value shown for buildings?

The term "buildings" implies something of a permanent nature and the tarpaulin is obviously only temporary. In this case the cost and value could be correctly stated but the manner in which it is shown is misleading.

The auditor must ensure that the presentation is correct.

- 4) Stress again that the auditor must confirm six essentials regarding assets if he is to meet his objectives.

- Existence
- Cost
- Ownership
- Completeness
- Value
- Presentation

If these are confirmed then the auditor can be confident about giving a positive opinion on the truth and fairness of the accounts.

- 5) Hand out the sheets "Balance Sheet - Nationwide Co-operative" and "Asset Register".

While the trainees are studying these for a few minutes, make sure that the six essentials of verification of assets are clearly displayed on the chalkboard.

- 6) Do not spend too much time discussing the balance sheet as this is only intended to give comparison for the figures you will be working with throughout this topic. It should be enough for the trainees to recognise that this seems to be a fairly well financed co-operative that has good reserves but is not very liquid in terms of working capital.

Refer to the "Asset Register" and ask the students what they would do to confirm the first aspect of verification - that the building and vehicles included on the register physically exist.

- The obvious answer to this is to inspect each and every item. For practical purposes this is not always possible or advisable. It may be inefficient for the auditor to visit each branch; in any case often vehicles would be in use at the time of his visit. He should inspect as many assets as practical in terms of time and cost but there are other methods of verifying existence.
- For vehicles it is possible to inspect details of licence payments. Few people will pay a licence fee for a car that doesn't exist. In the same manner,

rates payments or equivalent tax charges can be examined for buildings.

- Enquiries should be made from third parties. Ask someone who comes from the area where the building is situated. A few general questions will soon establish if the building is there or not. For vehicles you could take a trip round to the transport department and ask the drivers and mechanics a few questions. Trainees should realise that when talking to third parties questions should be kept vague and general. If you ask the person a direct question about one asset he may think you have found something wrong and may become evasive with his answers. Another reason for keeping the questions general is that you can often obtain information about other matters which you would not otherwise have known.
- 7) How would the trainees go about checking the cost of the assets of "Nationwide Co-operative"?
- This is a matter of checking previous audit record for older assets and the accounting records for items purchased during the year being audited. If the internal controls are adequate it should be reasonable to rely upon the accounting records and therefore little extra audit will be required.
 - Trainees should also review the minutes of Committee meetings as all asset purchases should be approved by the committee and this approval should include the price to be paid.
- 8) What is required when confirming "Nationwide Co-operative" actually owns the fixed assets on the list?
- Ownership is normally confirmed by documents. For vehicles there are registration books and for land and buildings there will be title-deeds. If the deeds are held by the co-operative's lawyer the auditor

should either inspect them at the lawyer's office or obtain from him written confirmation of the deeds held.

- As a back-up, the auditor should inspect insurance agreements as all fixed assets should normally be covered.

- 9) Value is often the aspect that takes up most of the auditor's time. How can he decide whether the Net Book Values given by "Nationwide Co-operative" are reasonable?

What factors affect the Net Book Value? Usually it is the depreciation charged and this is set by the accounting policies of the co-operative. Over what period should an asset be written off? Students should be able to respond that this should be over the period of which the asset will be of use to the co-operative. In accounting terms this is known as "useful life".

You are told that Nationwide has set depreciation rates of .

- Buildings - 10% p.a. Reducing Balance
- Motor Vehicles - 20% p.a. Reducing Balance

Does this seem reasonable for the country you are holding the course in? This obviously depends on local factors. The trainees will be able to give their opinions but generally it must be expected that the policy of depreciating all vehicles at the same rate is not appropriate. Most developing countries are experiencing the effects of inflation and a rate of 10% for buildings would seem to be excessive.

What effect does calculating depreciation annually have? If a lorry is purchased in December is it fair that it should be given the same depreciation as a similar lorry purchased 11 months before in January.

It would seem that the auditor should recommend that "Nationwide" review their depreciation policies in order that these reflect the useful lives of the assets and give fairer values to the assets.

There is a complication in reviewing accounting policies. It is important that policies are applied consistently from year to year. Accounts can be manipulated by changes in policy. For example if "Nationwide" decided to change to no depreciation for buildings and only 10% for lorries in 1991 then this would decrease the depreciation by approximately \$15,000 and profits would be increased by the same sum.

The auditor should be suspicious of management who continuously change accounting policies. This could be a sign of manipulation in order to show the position management want rather than the fair position. This problem has to be balanced against the need for accounting policies to reflect the operating circumstances of the cooperative which are constantly changing.

- 10) As a break from subjective thought, ask the students to check the depreciation calculations using the depreciation factors given.

This is to demonstrate that auditors need not go through the laborious process of calculating each year's depreciation since the date of purchase, but that the table can be used instead. For example:

- Office built 1979 therefore 13 years' depreciation required
- Cost \$32,000 x (0.348 x 0.729) (10 years plus 3 years)
- Net Book Value = \$8,118
- Value given \$8,120; therefore calculation is correct.

The trainees will find that the lorry purchased in December 1989 has only been depreciated for one year. Pre-

sumably the auditors would have picked this up the previous year and have put a note of the reason for this in the audit file. Ask the trainees what this reason might be?

Perhaps payment was made in 1989 but delivery was not until January 1990. Maybe the lorry was received in December but not licenced or used until the new year. These would be acceptable reasons for not depreciating in 1989 under the concept of "Useful life", which is unlikely to begin before an asset is put into use, but does not explain why there is no depreciation charge in 1990. Students may say that there are small differences in each value and may wish to query this.

For example: Motorbike purchased 1989 therefore 3 years' depreciation.

- Cost	\$2,000	x	0.512	=	\$1,024
- Value Given					<u>\$1,000</u>
- Difference					\$24

In terms of the total fixed asset value of \$143,000 this difference cannot be considered material and is probably due to rounding differences. The trainees should keep materiality in mind, remembering that they should be concerned with fairness rather than absolute accuracy.

- 11) Completeness is not easy to ascertain but auditors with experience and a knowledge of the society they are auditing should be able to establish if anything material has been omitted.

Ask the trainees if they think anything has been omitted by "Nationwide Co-operative"?

There is no mention of:

- Office furniture;
- Office equipment;
- Shop fittings.

It is possible that the co-operative has a policy of writing these off in the year of purchase but this is not likely to reflect the assets' useful lives.

In the preamble to "Nationwide Co-operative's" balance sheet it is stated that there is a main shop and 6 other branches. Only 4 are included on the asset register. Presumably the other buildings are rented but the auditor must check this.

An experienced auditor should know what assets a co-operative such as "Nationwide" require for operation. By keeping his eyes and ears open he will be able to satisfy himself that all material assets have been included.

NATIONWIDE CO-OPERATIVE LIMITED
BALANCE SHEET

As at 31 December 1991

Fixed Assets		143,000
Current Assets		
- Stock	220,000	
- Debtors	10,000	
- Bank	33,000	
- Cash	32,000	
	<u>295,000</u>	
Current Liabilities		
- Trade Creditors	90,000	
- Members' Deposits	50,000	
- Accrued Charges	6,000	
- Patronage Bonus	8,000	
	<u>154,000</u>	
Net Current Assets		<u>141,000</u>
		<u>284,000</u>
Represented by Members' Shares		44,000
Reserves		
- General Reserve	90,000	
- Development Reserve	<u>50,000</u>	
		140,000
Long Term Liabilities		
- Bank Loan		<u>100,000</u>
		<u>284,000</u>

Nationwide Co-operative Limited is a small nationwide consumer co-operative society which has been in operation since 1979 and has approximately 40,000 current members. It has expanded from a beginning of one store and now operates 6 branches in addition to the original shop.

NATIONWIDE CO OPERATIVE LIMITED
FIXED ASSET REGISTER

	Date	Cost	Accum' Dep'n	Net Book Value
		\$	\$	\$
<u>BUILDINGS</u>				
Head Office	06/79	32,000	23,880	8,120
Aguna Shop	04/71	8,000	5,750	2,250
Branga Shop	01/84	10,000	5,700	4,300
Carja Area Store	08/86	12,000	5,630	6,370
Head Office Extension	02/87	12,000	4,920	7,080
Kidia Shop	03/88	13,000	4,470	8,530
Fragia Shop	10/90	15,000	2,850	12,150
Head Office Extension	12/91	18,000	1,800	16,200
		<u>120,000</u>	<u>55,000</u>	<u>65,000</u>
(Depreciation 10% reducing balance calculated annually)		=====	=====	=====

	Date	Reg' Number	Cost	Accum' Dep'n	Net Book Value
			\$	\$	\$
<u>VEHICLES</u>					
10 Tonne Lorry	04/87	WDB12	20,000	13,450	6,550
Beetup Car	06/88	CR234	7,000	4,140	2,860
2 Tonne Pick-up	08/87	P4023	8,000	4,730	3,270
Izzy Motorbike	09/89	MB809	2,000	1,000	1,000
10 Tonne Lorry	12/89	LY318	25,000	5,000	20,000
2 Tonne Pick-up	01/90	PU441	10,000	3,600	6,400
New Car	06/90	1B124	8,000	2,880	5,120
10 Tonne Lorry	06/91	LY556	30,000	6,000	24,000
2 Tonne	10/91	PU714	11,000	2,200	8,800
			<u>121,000</u>	<u>43,000</u>	<u>78,000</u>
(Depreciation 20% reducing balance calculated annually)			=====	=====	=====
TOTAL			<u>241,000</u>	<u>98,000</u>	<u>143,000</u>
			=====	=====	=====

DEPRECIATION FACTORS
(Reducing Balance Method)

		10% p.a.	20% p.a.
Year	1	0.900	0.800
Year	2	0.810	0.640
Year	3	0.729	0.512
Year	4	0.656	0.410
Year	5	0.590	0.327
Year	6	0.531	0.262
Year	7	0.478	0.210
Year	8	0.430	0.168
Year	9	0.387	0.134
Year	10	0.348	0.107

SESSION 7.2

VERIFICATION OF FIXED ASSETS

Objective: To enable trainees to verify fixed assets.

Time: 1 to 1 1/2 hours.

Material: Balance Sheet - "Nationwide Co-operative Limited" (previous session);
Asset Register - Nationwide Co-operative Limited" (previous session);
Extract of "Committee Minutes".

Session Guide:

- 1) In this session you will continue from the areas covered in session 7.1 and this will be developed by further reference to "Nationwide Co-operative Limited".

Make sure the trainees have the Balance Sheet and Fixed Asset Register of Nationwide Co-operative.

- 2) The Balance Sheet simply shows a single figure of \$143,000 in respect of fixed assets.

Do the trainees consider the presentation in the accounts to be adequate? Does it give sufficient information for the users of the accounts?

Probably not - for four reasons:

- There is no split between categories;
- The accounting policies are not disclosed;
- The cost and depreciation are not given;
- Additions and disposals, if any, are not disclosed.

Without adequate information the users of the accounts will not be in a position to make reliable judgements.

Can the additional information required, be given in a

manner which does not clutter up the balance sheet?

If the trainees have experience of accounts they will know that this additional type of information is usually shown in notes to the accounts. Ask the trainees if they can prepare a suitable note to the accounts.

If you have an overhead projector available you can have the following prepared beforehand as an example.

NATIONWIDE CO-OPERATIVE LIMITED

Year ended 31 December 1991

Note to the accounts

	Land and Buildings	Motor Vehicles	Total
	\$	\$	\$
Cost as at 01 Jan. 91	102,000	80,000	182,000
Additions for year	18,000	41,000	59,000
Disposals in year	-	-	-
Cost as at 31 Dec. 91	<u>120,000</u>	<u>121,000</u>	<u>241,000</u>
Depreciation at 01 Jan. 91	47,770	23,450	71,220
Charge for year	7,230	19,550	26,780
Disposals in year	-	-	-
Depreciation at 31 Dec. 91	<u>55,000</u>	<u>43,000</u>	<u>98,000</u>
NET BOOK VALUE 01 JAN. 91	<u>54,230</u>	<u>56,550</u>	<u>110,780</u>
NET BOOK VALUE 31 DEC. 91	<u>65,000</u>	<u>78,000</u>	<u>143,000</u>

Accounting policy

Fixed assets are valued at cost less provision for depreciation. Depreciation is calculated to reduce the value of the assets over the period of its useful life.

- Buildings 10% p.a. Reducing Balance
- Motor Vehicles 20% p.a. Reducing Balance

3) How will this help the accounts user?

- He will have a better idea of the scope of assets owned by "Nationwide Co-operative Limited".
- He can make his own judgement as to the suitability of the depreciation policies used.
- He can estimate the possible replacements that will be required in the future, and therefore the capital required to finance this investment.

4) Hand out the sheet "Extracts of Committee Minutes". This represents notes made by the audit clerk who reviewed the committee minutes. He considered these points may be relevant to whoever was allocated the fixed asset audit.

Ask the trainees to consider each point in turn. How does each affect the value attached to the fixed assets in the balance sheet?

- a) The lorry as a fixed asset no longer exists. It should be written off the register. However, the parts still have some value and should be included under stocks (current assets). The auditor should inspect what remains of the lorry and try to ascertain the current value.
- b) This affects the ownership of the buildings. If the bank foreclosed on the loan they would be entitled to take possession of the co-operative's buildings and sell them to recover the value of the loan. Some mention of this would be required in the accounts to show a fair view.
- c) The total value of the site would appear to be far in excess of the book value (\$31,400). However, it is only the land that the developer is interested in and no value is given to land in the asset register. It isn't clear if "Nationwide" even own the land. The auditor would be required to establish who owns the land and should recommend to the Committee that they

arrange for an independent valuation of land and buildings.

Ask what effect a revaluation would have on the overall picture shown by the accounts. The net asset value would be increased and the co-operative would be seen to be in a healthier financial situation than currently shown.

- d) This is the authorisation for purchase of the new lorry and will help the auditor in his verification of cost and ownership.
- e) Nothing has happened at the year-end date and therefore no changes are necessary to show the true position. The value of two years' free rent will have to be considered in the following year's audit and a note for the file should be made.
- f) A long-term hire does not affect the ownership of the pickup but the auditor should contact "Delivery Co-operative." to confirm that the pickup still exists.
- g) As in (d) above. Authorisation for purchase and confirmation of cost.
- h) Is the value of the building affected? Is the rest of the shop about to fall down as well?
- i) The office extension is not in use at the end of the year and effectively does not fully exist. It should be classified as Capital Work in Progress. The pre sentation and value are incorrect. Depreciation should not be charged until the building is in use as that is the time its useful life should commence.

Another point here is that "Nationwide" have contracted a future liability (of \$5,000) for the completion of the extension, which should be disclosed in a note to the accounts.

- j) Does the pickup still exist? Does it have any value to the co-operative? The auditor should find out what has been decided by the insurers. If a write-off in insurance claim has been made then the vehicle is ow-

ned by the insurers and not the co-operative.

- 5) In summarising the session, you should emphasise the importance of verifying assets as this is a major part of auditing.

Every co-operative must have assets for it to operate and the auditor can only satisfy himself that they are truly and fairly stated in the accounts if he has verified each of the essentials concerned:

- | | |
|-------------|----------------|
| - Cost | - Completeness |
| - Existence | - Ownership |
| - Value | - Presentation |

Audit: Nationwide Co-operative Limited
 Year Ended: 31 December 1991
 Subject: EXTRACT OF COMMITTEE MINUTES
 (Ref Fixed Assets).

Prepared by: A. Clarke - Date, 12 February 1992.

<u>Item</u>	<u>Meeting</u> <u>Date</u>	<u>Notes</u>
A.	March 91	Lorry (Registration no. WDB12) taken out of service and to be cannibalised for spare parts. Spares said to be worth more than book value of vehicle.
B.	April 91	Bank loan (\$100,000) renewed for a further three years. Security over buildings in favour of bank also renewed.
C.	May 91	Property developer verbally offered \$100,000 for head office site which he wished to turn into a multi-storey car park. Board refused to consider the offer.
D.	June 91	Purchase of new 10 tonne lorry approved at cost of \$30,000.
E.	Aug' 91	Branga shop subject to compulsory purchase order with effect from 1 March 1992. No payment offered but building in new shopping centre to be offered rent-free for two years.
F.	Sept' 91	Pickup (Reg' No P4023) hired to Delivery Co-operative for a period of 6 to 9 months.
G.	Sept' 91	Purchase of new pick-up approved (\$11,000).
H.	Nov' 91	Anguna shop storeroom damaged by storm. Decided not to rebuild but to rent adjacent building as storeroom instead.

- I. Dec' 91 Office extension will not be complete until end of January 1992 as builder was delayed by bad weather. When keys are handed over final payment of \$5,000 is due.
- J. Dec' 91 Pickup (Reg' No PU714) severely damaged in accident. May not be repairable. Committee are awaiting insurer's report.

Assignment :

Consider how the above items affect the value of Nationwide Co-operative's Fixed assets.

SESSION 7.3

VERIFICATION OF CURRENT ASSETS - STOCK

Objective: To enable trainees to apply the procedures for verification of assets to stock.

Time: 3 to 4 hours. (Plan to have a break during the session).

Materials: Case Study "Nationwide Co-operative Stocktaking Instructions".
"Nationwide Co-operative Balance Sheet" (Previous Session).

Session Guide:

- 1) In many co-operative societies the single largest type of current asset will be stock. It is also the asset which can give the auditor most problems when he is trying to verify the truth and fairness of the figure in the accounts.
- 2) Ask the trainees to calculate the surplus for "Nationwide Co-operative" if it is achieving a return of 8% on net assets (fixed plus current assets, minus current plus long-term liabilities).

Net Assets = \$143,000	154,000	
295,000	100,000	
<hr style="width: 100px; margin-left: 0;"/>	<hr style="width: 100px; margin-left: 0;"/>	
438,000	254,000	= \$184,000
<hr style="width: 100px; margin-left: 0;"/>	<hr style="width: 100px; margin-left: 0;"/>	
Surplus = \$184,000	x 8%	= \$14,720

What would be the effect of a 10% error in stock valuation?

- Returnable stock
- Stock in transit
- Stock in bond
- Containers, bottles etc.
- Items on the move
- Items held in a warehouse controlled by Customs and Excise.

As can be seen, the range of items is large and this can create problems in terms of the 6 essentials of verification.

- 5) Hand out the case study "Stocktaking Instructions". Ask the trainees to divide into groups of three or four. Allocate each group one of the assignments set in the case study.

Give the trainees twenty minutes or so to compile their answer to the question. Remind them that they should base their answers around the essentials of verification which were discussed in the previous sessions.

- 6) When the trainees are ready, ask one from a group commenting on the manager's instructions to give their answer. Encourage the remainder of the trainees to comment on the group's answer.

Guide the discussion to ensure the following points are covered.

- Planning

The majority of the stocktake procedure is concerned with existence of stock and there must be good planning to ensure the stocktaking is carried out carefully and systematically. The instructions have been sent out in good time but they are vague and could easily be interpreted differently by those responsible for the stock count. More detailed thought is required.

- Stock Arrangement

Stock areas have to be of a manageable size and tidily

arranged for one person to be able to exercise sufficient control over the count. Instructions should be given to ensure stocks are neatly arranged before the count and that one type of stock is separated from another. For example, bags of rice should be clearly separated from bags of sugar in order to avoid any confusion. This should help ensure that all stocks are counted (completeness) and only counted once.

- Counting and Recording Procedure

In a shop there are likely to be goods on the shelves and more of the same goods in the store. Should these be counted on the same stock sheets or recorded separately? Should two types of torch batteries which are the same size but of different makes be recorded as the same type of item or not? The stocktakers need to have clear instructions or the person collating the sheets will have problems later on. It is often useful for the stocktakers to mark items or areas once they have been counted to avoid the possibility of double counting.

- Unit of Measurement

Nothing has been said about ensuring the unit is clearly stated. Does a box of soap containing six bars count as 1 or 6? Should sugar be counted by bag or by weight? The stocktakers must make this clear or the value of the stock will be incorrect.

- Stock Sheets

Information must reach Head Office in a useable manner. For this reason, prenumbered stock sheets should be issued to each stock area. This should help eliminate confusion and assist the stocktakers. All stock sheets must be signed by the stocktaker and supervisor and be returned to Head Office where they will be checked to ensure that none have been lost.

- Cut Off

This is the accounting term used to ensure that stock movements around the year end are correctly recorded in

the books. Ideally "Nationwide" should try to stop any deliveries for a couple of days either side of the stocktake. However, areas should be set aside for any deliveries which do arrive, to be stored separately.

These have to be recorded but must be clearly noted for Head Office to check that the correct procedure is adopted. The managers should be asked to send in details of the last five delivery notes in order that Head Office can check that nothing has been omitted or recorded twice (e.g. a delivery from area store to shop being counted at both).

- Condition of Stock

It is essential that any defective, damaged or obsolete stock is clearly identified, as this will reduce the value of the item.

- Independent Observer

This has been arranged but it is not clear if he has been issued any instructions. His job is not to participate in 'the count but to check that the counters are carrying out their tasks as instructed.

- Third Party Goods

Quite often it happens that stock has been sold but it is a few days before it is collected by the customer. Any such items must be clearly identified as must containers on which a deposit has probably been paid.

- Goods with Third Parties

The opposite to the point above. Has the co-operative purchased any goods which are being stored elsewhere or which haven't yet been collected. These must be included and someone at Head Office should be made responsible to ensure the count is complete in this respect.

- 7) If you have sufficient time, ask one of the groups of trainees to redraft the manager's stocktake instructions taking into consideration the points discussed.

Those who are involved in this could produce a standard stock count from which they think would be suitable for "Nationwide Co-operative's" stocktake.

- 8) Ask a member from another group to explain their answer to the question on the auditor's work regarding "Nationwide's" stocktake.

As before, discuss this with the trainees bringing out the following points.

Before the stock count

- Responsibility

It is not the auditor's responsibility to count stock. He is only required to satisfy himself that the value given to stock in the accounts is true and fair. It is common practice for auditors to attend year-end stock counts especially where there are significant stock holdings such as is the case at "Nationwide Co-operative". The auditor must plan his work before the year-end and consider whether he should attend the stock count. He must be aware of the possibility of being sued for negligence should his opinion be proved wrong.

- Coverage

Stock is a material figure in "Nationwide's" accounts but how much of it should the auditor verify in order to meet his objectives? This will partly depend on his evaluation of internal control from previous years and from his assessment of the stocktake instructions issued. If controls are reasonable it is unlikely that the auditor would consider it efficient for even possible) to check the stock count at every area.

Consider the figures given for "Nationwide's" stock at 30 November 1991.

By attending the stock count at two places he can cover over 60% of the anticipated stock value.

Head Office Store	\$65,700
Head Office Shop	33,300
Carja Area Store	46,700
Carja Shop	17,800
	<hr/>

\$163,500 out of \$259,600

The experienced auditor will be able to judge if this would be sufficient coverage considering his knowledge of "Nationwide Co-operative".

- Planning

The auditor must familiarise himself with the nature, volume and location of stocks. His planning must include consideration of perishable or high value goods and the quality of available audit staff in order that he can set the work of his team at the required level.

During the stock count

- Observation

The auditor is in a position similar to the committee member who is attending the shop count at "Nationwide Co-operative". He is an independent observer who watches to see that instructions are correctly carried out.

- Test Check

He would be expected to carry out a number of test checks to ensure that the count is correct. These checks should be made from physical stock to the stocksheets and from the stocksheets to the goods themselves. This is to check that all items existing are recorded and that all items recorded exist.

- Records

There is no point in attending a stocktake if the auditor does not keep records of the work he has done, especially of items to be followed up.

- Overall Impression

The auditor must gain an overall impression of the effectiveness of the stock count and must form a conclusion as to whether the count is reliable. If he is not sure of this then he should insist on a recount being made.

- Communication

Let the co-operative management know what the auditors have observed and if there are any problems which require further work.

After the stock count

These procedures will be performed during the course of the final audit.

- Test Final Records

Check that the final stock sheets have been prepared from the count records and that all count sheets have been included. Test check pricing, additions and extensions.

- Examine Cut Off

Check that stock movement around the year-end are correctly reflected by the accounting records.

- Review Value

Review the final records for provisions reducing the value of damaged, defective, slow-moving or obsolete goods.

- Follow Up

Notes made at stock count especially any relating to cut off or items suspected of having a reduced value.

- Overall Tests

The auditor's work on stock is not complete until he has made comparisons of the total figure with other relevant statistics such as last year's (or last month's or a similar co-operative's) quantities, value, and breakdown

of major stock components. The reasons for any significant variations must be known to the auditor before he can give an opinion on the stock value.

- Discuss with Management

Suitability of pricing methods provision policies (e.g for damaged and slow moving items) and any other relevant matters.

- Conclusion

The auditor must conclude whether, in his opinion, the value of stock stated in the accounts is true and fair

- 9) On many occasions mention has been made of value, but what do the trainees understand by this to be in accounting terms?

The British Statement of Standard Accounting Practice on Stock states that stock should be valued at:

"The lower of cost or net realisable value".

Net realisable value basically means "what it can be sold for".

- 10) Get the trainees to consider the following cases which might have been found during "Nationwide's" stock count. How would they value the stock in each case?
- a) Head Office store has 6,000 Lion Brand "U2" size torch batteries. The area store and shops have a further 5,000.
These have been purchased in three lots at a cost price of \$0,40, \$0,42 and \$0,45 respectively but the stock records cannot identify which lots are in which store area.
- b) The acc-punts department have calculated that the transport cost of getting the batteries from the Head Office Store to the area store is \$0,05 per battery.

c) Cheapo Supermarket (1km from Nationwide's Head Office) is selling the same batteries for \$0,35 each.

In each case the value will depend on the policies determined by the management of Nationwide and it is the auditor's duty to establish whether these policies are suitable.

In a): The policy could be to use an average price of \$0.4233 ($0.40 + 0.42 + 0.45 = 1.27/3$) giving a total value of \$4,656.30 ($11,000 \times \0.4233).

For b): It is quite acceptable to include transport costs when calculating the cost of stock and therefore the value could become \$4,906.30.

In c): "Nationwide" should investigate the reason why Cheapo are able to sell below "Nationwide's" cost price. If they have found a cheaper supply source then "Nationwide" should reduce value of their stock to \$3,850.00 (a) of \$4,100.00 (b). However, if Cheapo are selling the batteries as a "loss leader" or are trying to unload them as their shelflife is nearly finished or if they have a very limited stock then there would be no need for "Nationwide" to reduce its valuation.

NATIONWIDE CO-OPERATIVE LIMITED

Date: 15 December 1991

From: General Manager
 To: Shop Managers and Head Storekeepers
 Subject: Stocktake Instructions - 31 December 1991

All stocks will be physically counted and recorded on Monday 31 December 1991 and shops will close at 12.00 midday to allow sufficient time for counting.

At shops, it is the manager's responsibility to accurately count and record stock. At stores, it is the responsibility of the head storekeeper.

In order that the management can be certain that the count is undertaken properly, a committee member will be in attendance at each shop. I will be present at the Head Office store and my deputy will attend the Area Store count.

Stock sheets must clearly record the item description and number of items.

All stock sheets must be returned to Head Office by Monday 6 January 1992 without fail.

Note for the Auditor

STOCK AT 30 NOVEMBER 1991

Shops and Stores	Goods for Resale	Fuel \$	Vehicles Spares	Stationery	Total \$
Head Office Store	54,500	6,000	\$2,000	3,200	65,700
Head Office Shop	33,300				33,300
Anguna Shop	21,600				21,600
Branga Shop	19,500				19,500
Carja Shop	17,800				17,800
Kidia Shop	22,100				22,100
Edrund Shop	15,600				15,600
Fragia Shop	17,300				17,300
Carja Area Store	41,300	3,000	1,200	1,200	46,700
Total	\$243,000	9,000	\$3,200	\$4,400	259,600

Assignment :

- 1) Review the stocktake instructions and suggest improvements.
- 2) What work is required by the author:
 - a) before the stockcount;
 - b) during the stockcount;
 - c) after the stockcount.

SESSION 7.4

VERIFICATION OF OTHER CURRENT ASSETS

Objective : To enable trainees to apply the procedures of asset verification in relation to other current assets.

Time : 1 to 1 1/2 hours.

Materials : "Nationwide Co-operative Balance Sheet" (Previous Session);
"True/False" Question Sheet.

Session Guide :

- 1) Discuss with the trainees what can be included in "current assets" (in addition to stock) and ask for examples of each.
- 2) Divide trainees into groups of 3 or 4 persons and hand out the "True/False" question sheet and give the trainees ten to fifteen minutes to answer the questions.
- 3) Ask the trainees how many answered "true" and how many "false" to question (a). Ask representatives of each to explain their reasons for their answer and encourage the trainees to discuss the subject.

It may be that all trainees will correctly answer "true" but they should be able to explain why this is the case. If you go through each of the 6 essentials described in the previous two sessions you will see that all of these are relevant to all types of assets.

- 4) Refer the trainees to "Nationwide Co-operative's" Balance Sheet and ask whether they would expect an auditor to spend much time on verifying the debtors figure of \$10,000.

The debtors balance represents 3.4% of the total current assets. The auditor may not spend a lot of time verifying the balance but he still has to assure himself that there are no material errors or omissions.

What do the trainees think might make up this amount?

It would appear from the size of the figure, that credit sales are not allowed. Therefore the balance might be made up to the following type of items.

- Staff loans
- Rent and other Prepayments
- Deposits for utilities of fuel

Can the trainees suggest methods of how the auditor should test these?

- He should determine the system of internal control relating to debtors.
- Obtain a schedule of debtors which should be checked to the ledger and for arithmetical errors (value).
- Review the items included on the schedule to ensure they are correctly classified (presentation).
- Contact members of staff to confirm their balances (existence and value).
- Review subsequent payments after the year-end and follow up overdue items (value).
- Examine contracts regarding prepayments (e.g. lease agreements) and payments made (cost and ownership).
- Consider the necessity for a bad debt provision (value).
- Compare with previous years and consider if all possible debtors have been included (completeness).

If the debtors balance was significant in terms of total current assets the auditor would have to carry out a debtors circularisation exercise. He would write to a sample of debtors asking them to confirm the balance.

Discuss with the trainees the process of carrying out a debtors circularisation exercise.

- Select a sample of debtor balances for circularisation .
- The co-operative should write on their letterhead to debtors, asking them to reply direct to the auditors. (A standard letter can be seen in most text books on audit);
- The auditor should check that the amount of debt stated on the letter agrees with the co-operative's records;
- The auditor should seal and post the letters (enclosing a stamped addressed envelope to facilitate replies);
- Auditor receives and evaluates replies;
- Auditor follows up any responses which have not been received;
- Auditor considers his findings in relation to other verification work performed on debtors.

A debtors circularisation exercise is an excellent method of checking if debts are overstated as most people who think the debt is incorrectly high will dispute the amount. However, those who feel they actually owe more than they are asked to confirm are not likely to say that it is wrong!

The auditor would also be expected to examine significant movements around the year end. Ask the trainees if they know why this should be?

If the management wish the accounts to show a better position than they actually do, then the period this manipulation is most likely to happen is towards the end of the year. The auditor has to be aware of the possibility of "window dressing". This involves the presentation of figures which are not actually untrue but are designed to mislead.

- 5) Ask for answers and explanations to question (b).

In this case the answer is false. It can at times be a problem but it is certainly not one of the biggest. If someone is trying to manipulate a set of accounts they are usually trying to show an improved performance from what has actually happened. This can only be done by inventing or overvaluing assets, not by omitting them.

- 6) For question (d) the answer is false. Credit notes issued shortly after the year-end may relate to sales made in the year which is being audited and may affect the profit for that year.

For example, it would have been possible for Nationwide to have sold a large amount of rice in the last fortnight of December. If this rice was bad, the customer would have every right to receive credit for his purchase. If a cash refund or credit was not issued until January 1992 this still relates to 1991 sales and any profit taken on the sale should be eliminated from the 1991 accounts.

- 7) Ask the trainees how they would verify bank balances?

- As with all items in the accounts they should start by examining the internal control systems which relate to the bank balances. If these are strong and consistently operated then this greatly reduces the risk of error.
- The best way to confirm any item concerning a bank is to obtain a letter from the bank confirming all balances held with the bank at the year-end. This letter should also cover items such as loans, mortgages, securities, guarantees and any other liabilities.
- Usually a standard letter should be sent to the bank two weeks before the year-end. This should give time for a reply to be received before the audit commences. Any audit manual will provide a draft bank confirmation letter if you feel the trainees should see one at this stage.

As this letter comes from an independent third party, it can be regarded as audit evidence of the highest quality (unless you are given reason to suspect collusion between the co-operative and the bank).

- Examine bank reconciliations . In particular investigate all uncleared deposits and outstanding cheques.
- Examine unusual or large movements in the bank accounts around the year-end. As with debtors, and stock, bank balances are a favourite area for "window dressing".

- 8) The correct answer for (e) is "true" . This is because so much more information can be obtained from the bank than simply a confirmation of the balance on an account. The bank letter may identify liabilities that have been omitted or give details of security held.
- 9) The correct answer to question (f) may be more difficult for trainees to understand. Obviously an error of \$10 would not be material in relation to Nationwide's net assets of \$184,000. However, if the reason for the difference in the reconciliation has not been traced it could be possible that there is more than one error and these could be compensating errors.

For example, one error could understate the balance by \$50,000 and the other overstate the balance by \$49,990 giving a net difference of \$10. The difference of \$10 could therefore include a material error and the statement must be considered "false" unless the auditor knows the reason for the difference. Errors must not be netted off against each other. Each error must be evaluated on its own.

- 10) All trainees should have a good idea how to verify cash balances. You count it! But ask the trainees what problems there may be in doing this at "Nationwide" Co-operative?

The total balance of \$32,000 will probably be spread over 10 or 12 locations. As with stock it would not be economic or efficient for the auditor to count all the balances and usually he will settle for a sample. This can generally be done at the same time as attending to the stock count.

If this is not possible, the auditor should obtain a written certificate from the branch managers, countersigned by the person attending the stockcount, confirming the cash held.

What should the auditor be specifically on the lookout for? Discuss why each of the following could indicate problems.

- IOU's;
- Personal cheques from the person in charge of the cash;
- Shortages and excesses;
- The figure being used for reconciliation at a branch differing from the figure being used by the head office.

11) The answer to question (g) will generally be "true" as consumer co-operatives sales will usually be by cash and they are likely to need significant amount as floats. A healthy co-operative on the other hand is unlikely to require high cash balances.

12) Question (h) refers to an essential part of verification of assets and liabilities. The auditor must make a comparison of the current figures with the previous year's figures.

Apart from indicating if all items have been included it will help ensure a consistent presentation is maintained

CURRENT ASSET VERIFICATION

True/false question sheet

- a) The verification of current assets requires the auditor to consider the same essential as for the verification of fixed assets. True/False
- b) One of the biggest problems found when verifying assets is to ensure that no assets have been omitted. True/False
- c) When checking staff loans at "Nationwide" Co-operative a member of staff complained that a repayment made in December 1991 had not been recorded on his account. This is evidence of fraud. True/False
- d) Credit notes issued by Nationwide in January 1992 are not relevant to the audit for the year ending 31 December 1991. True/False
- e) A confirmation letter from the bank should be requested even if the latest bank statement is available. True/False
- f) A difference of \$10 was found in Nationwide's bank account reconciliation. The auditor would not need to investigate this difference as it could not be considered a material error. True/False
- g) Cash balances would be expected to be higher at a consumer co-operative than at a health co-operative. True/False

- h) Comparison with the previous year's figures is required as part of the process of ensuring all assets are included in the accounts.

Assignment :

Consider whether each of the above statements is true or false.

SESSION 7.5

VERIFICATION OF LIABILITIES

Objective : To enable trainees to verify liabilities correctly.

Time : 2 to 2 1/2 hours.

Materials : "Nationwide Co-operative" Balance Sheet Previous Session).
"Creditors Reconciliation" Worksheet.

Session Guide :

- 1) From looking at the balance sheet of "Nationwide Co-operative Ltd." ask the trainees to identify three classes of liability and ask them to explain the differences between each.

These are:-

- Current Liabilities: Amounts payable within one year;
- Long-Term Liabilities: Amounts payable more than one year from the balance sheet date;
- Members Funds: Funds which may be repayable at some future date.

The third category is often not considered to be a liability but the co-operative bye-laws are likely to include provisions covering the disposal of shares by members. They should also state the procedure to be followed in the event of the co-operative going into voluntary liquidation.

- 2) The first liability shown in the Nationwide Co-operative balance sheet is \$90,000 in respect of trade creditors.

This will principally consist of amounts due to suppliers of goods for resale in the shops.

Ask the trainees how soon they think this amount will have to be paid?

This will depend upon local circumstances but will usually be around 30 to 60 days. The co-operative will have to finance the payment partly from the bank balance, partly from cash balances and partly from January's sales. A material error in the trade creditors figure may affect the liquidity of the co-operative.

What information will be available at Nationwide for the auditor to check the balance shown?

There should be - A list of creditors;
- Individual creditor ledger cards;
- Suppliers' statements.

The most common method of verifying trade creditor's balance is to perform a reconciliation exercise between the supplier's statement and the balance shown on the individual creditor's ledger card.

- 3) Hand out the sheet "Creditors Reconciliation". Explain that the top half of this sheet represents the ledger card of Nationwide in respect of dealings with Wholesale Suppliers Ltd. The second part represents a statement sent to Nationwide by Wholesale at the beginning of January 1992 detailing their view of the transactions between the two organisations for the previous three months.

Split the trainees into small groups and ask them if they can establish the balance owed by Nationwide to Wholesale Suppliers Ltd. at 31 December 1991 (i.e. reconcile the account).

They should also note any items which require further investigation and be able to suggest how the difference might have occurred.

Do not allow more than 30 minutes for this exercise as groups who do not have an answer within that time are unlikely to reach one without help.

4) The trainees should be aware that there are four types of differences which cause problems in this reconciliation.

- Differences in opening balances;
- Items appearing on Nationwide's records but not on Wholesale's statement;
- Items appearing on Wholesale's statement but not on Nationwide's records;
- Items on both sets of records but the amounts differ.

It is always useful to use a standard format when performing reconciliations and you could copy the schedule given on the next page.

CREDITORS' RECONCILIATION FORM

-----Co-operative.

Reconciliation Account with-----

Year End-----Prepared By-----Date-----

Balance per Account Ledger \$.....

<u>Add Outstanding Invoices</u>	Ref.	Amount	
	
	
	
	
			\$.....

<u>Less Outstanding Credit Notes</u>	.....	.....
	
			\$.....

<u>Other Differences</u>	.....	.....
	
	
			\$.....

Reconciled Balance \$.....

Balance per Suppliers Statement \$.....

<u>Less Outstanding Payments</u>	.....	.....
	
			\$.....

<u>Other Differences</u>	.....	.....
	
	
			\$.....

Reconciled Balance \$.....

- 5) Work through the records of Nationwide first establishing what is the same on Wholesale's records and what is different.

The difference in the opening balance amounts to \$12,377.55 which equals the amount received by Wholesale on 3 October plus the 2% discount taken.

Payment received	\$12,130.00 (98%)
	247.55 (2%)
	<hr/>
	\$12,377.55 (100%)

This is a timing difference only. Nationwide wrote the cheque before the end of September but it didn't get to Wholesale until the beginning of October. This has no effect on the difference in the balances at the end of December so does not need to be entered on the reconciliation sheet.

The next difference appears with invoice WS87199. Nationwide has recorded it as \$3,492.21 but Wholesale say it is \$3,942.21. The auditor would have to inspect the invoice to find out which is correct but for the purpose of this exercise assume that it is Nationwide who has made the mistake. The difference of \$450 should be added to Nationwide's records on the reconciliation sheet.

On 30 November Nationwide made a payment and took 2% discount of \$245.88 but it seems that Wholesale didn't get the cheque until 5 December (which is well after the 30 days stated requirement for discount to be allowed). Probably Wholesale has disallowed the discount and this has to be added back to Nationwide's balance.

The payment made on 30 December has not reached Wholesale in time to be included on their statement. This should be deducted from Wholesale's balance as an outstanding payment. This completes the review of Nationwide's records and now try the same process with Whole-

sale's statement. You have already established that the opening difference was due to a timing difference which resolved itself in October.

A credit of \$47.33 in respect of discount appears on the Wholesale statement. The auditor would have to check this but assume this is an item that Nationwide has missed. Enter this as an outstanding credit note.

The last item is invoice WS88043 dated 30 December 1991 for \$4,321.15. This is an outstanding invoice and should be added to Nationwide's records.

The reconciliation form should now look like this.

CREDITORS' RECONCILIATION FORM

----- NATIONWIDE -----Co-operative.
 Reconciliation Account with--- WHOLESale SUPPLIERS -----
 Year End:31 DEC 91 --Prepared By: A. CLARKE -Date, 15 FEB-92

Balance per Account Ledger \$18,640.80

<u>Add Outstanding Invoices</u>	Ref.	Amount	
	WS88043.	4,321.15	
	
	
			\$4,321.15

<u>Less Outstanding Credit Notes</u>			
	Disc1831	....47.33	
	
			\$47.33

<u>Other Differences</u>			
	Discount	...245.88	
	
			\$245.88

Reconciled Balance \$23,160.50

Balance per Suppliers Statement \$33,540.51

<u>Less Outstanding Payments</u>			
	....2481	9,731.41	
	Discount	198.60	
			\$9,930.01

<u>Other Differences</u>			
	WS87199	450.00	
	
	
			\$450.00

Reconciled Balance \$23,160.50

Ask the trainees if they can now conclude that Nationwide has understated the balance owed to Wholesale by \$4,519.70.

This may be the case but more likely the invoice WS88043 will refer to goods that were not included in the Nationwide stockcount at the year-end either because they had not arrived in time or because a policy had been set not to include late deliveries. If this was the case then it would be wrong to include the amount of \$4,321.15 as a liability and the understatement would amount to only \$198.55.

- 6) When considering assets there were 6 essentials of verification which the auditor has to cover in his work. Can these essentials be applied to the verification of liabilities as well?

Discuss each essential with the trainees. Can the essential be related to liabilities? Has the reconciliation of Wholesale's account provided sufficient information to verify the essential?

- Existence

The auditor must ensure that all liabilities shown in the balance sheet actually exist. However, in verifying assets the main danger is overstatement. In the case of liabilities the reverse is true, where the main risk is of liabilities being omitted. It is much more likely that management will (deliberately or mistakenly) exclude liabilities rather than include non-existent ones.

With reference to Wholesale's account there appears to be no doubt that the liability exists.

- Cost

Is not a factor that is relevant when verifying liabilities as it is difficult to establish what is meant as cost in this respect and because cost would always be overruled by the value owned in respect of the liability.

- Ownership

It is difficult to consider a liability to be something that is owned and therefore the auditor would be unlikely to verify this as a separate essential.

- Value (Owed)

The correctness of the value owed is essential for the accounts to show a true and fair view. This essential is a major part of liability verification and this is precisely what the reconciliation exercise was testing.

- Presentation

This is just as important for liabilities as for assets. Correct classification must be achieved or otherwise the accounts could be misleading to the user. In the case of Nationwide for example, if the Long-Term Loan was included in current liabilities it would appear that the society has serious liquidity problems. The reconciliation has indicated to the auditor that the items on the account are currently due and therefore the presentation is correct.

- Completeness

To verify that all liabilities that exist are actually included is essential and difficult. Without a day-to-day knowledge of the business, the auditor is at a disadvantage when it comes to identifying all possible liabilities and the reconciliation exercise will not help him.

Ask the trainees how they would test to ensure that all trade creditors for whom a liability exists, have been included by Nationwide Co-operative.

They would have to look through the invoice file and try to identify items that they would expect to be outstanding at the year-end, then check these to the list of creditors. They should also look through suppliers' statement to see if any are showing balances due which are not recorded by Verified Co-operative.

7) From this you can stress to the trainees that an auditor should concentrate on 4 factors when verifying liabilities and that these factors will apply to all three categories of liability that were discussed at the start of the session.

- Existence
- Value
- Presentation
- Completeness

8) Now ask the trainees to apply three criteria to each of the other liabilities shown in Nationwide's Balance Sheet. Discuss how they would test for each of them, including the different types of members' funds.

9) Discuss with the trainees what they understand by the term "Contingent Liability" and provide an explanation and examples if needed.

"Contingent Liability" - An event which may, in the future, result in a loss to the cooperative but the outcome of which is not certain at the date of signing the accounts.

10) How can the auditor check that no other liabilities exist that have not been included?

To finish the session, divide the trainees into two groups and ask them to write as many possible types of unrecorded liability (or contingent liability) as they can. They should also try to say how the auditor could test for these.

You may need to give some examples such as:

- Claims by employees for unfair dismissal.
- Bonuses for management.
- Returnable containers.
- Losses on forward contracts (contract losses and exchange losses).

- Pending law suits.
- Tax and National Insurance.

There are a great many possibilities and just as many tests which can be performed.

Do not let the trainees forget the simple tests such as:

- Obtaining a letter from the management (called a "Letter of Representation") which, among other things, states that there are no unrecorded liabilities. This does not absolve the auditor if there are unrecorded liabilities and he doesn't find them, but it should increase his confidence level. Few managers are willing to put something in writing to the auditors, when they know it is not true.
- Contacting the co-operative's lawyers and bankers.
- Reviewing contract files and staff files.
- Examining Pension Scheme Details.
- Comparison with the previous year's records.
- Reviewing what has happened since the year-end date (Post Balance Sheet Review).

One of the difficulties of trying to ascertain unrecorded liabilities is that they can be difficult to value. The auditor is not expected to know everything and if he needs help he is always to call in experts. For example, if there seems to be a problem with the funding of the pension funds and the auditor suspects that the co-operative will have to put in extra contributions, he should ask an actuary to carry out a valuation for him.

If the value of a liability is not certain (e.g. outcome of a court case) then the auditor must ensure that, if he considers that the amount could be material, details are adequately disclosed in the notes to the accounts.

CREDITORS' RECONCILIATION

NATIONWIDE CO-OPERATIVE LTD.
CREDITORS LEDGER CARD FOR WHOLESALE SUPPLIERS LTD.

Date	Description	Reference	Amount	Balance
30 Sep 91	Balance forward			\$14,350.00
15 Oct 91	Invoice	WS86554	8,346.44	22,696.44
26 Oct 91	Invoice	WS86973	3,947.47	26,643.91
27 Oct 91	Cheque	2665	(14,063.00)	12,580.91
27 Oct 91	Discount taken		(287.00)	12,293.91
15 Nov 91	Invoice	WS87124	6,437.80	18,731.71
26 Nov 91	Invoice	WS87199	3,492.21	22,223.92
30 Nov 91	Cheque	2738	(12,048.03)	10,175.89
30 Nov 91	Discount taken		(245.88)	9,930.01
09 Dec 91	Invoice	WS87395	16,322.68	26,252.69
28 Dec 91	Invoice	WS87706	2,318.12	28,570.81
30 Dec 91	Cheque	2841	(9,731.41)	18,839.40
30 Dec 91	Discount taken		(198.60)	18,640.80

STATEMENT FROM WHOLESALE SUPPLIERS LIMITED
AMOUNT DUE BY NATIONWIDE CO-OPERATIVE AT 31 DECEMBER 1991

Reference	Debit	Credit	Date	Balance
Balance			30/09/91	26,727.55
WS86554	8,346.44	0.00	02/10/91	35,073.99
Payment	0.00	12,130.00	03/10/91	22,943.99
Disc 1814	0.00	247.55	03/10/91	22,696.44
WS86973	3,947.47	0.00	16/10/91	26,643.91
Payment	0.00	14,063.00	29/10/91	12,580.91
Disc 1827	0.00	287.00	29/10/91	12,293.91
WS87124	6,437.80	0.00	06/11/91	18,731.71
Disc 1831	0.00	47.33	06/11/91	18,684.38
WS87199	3,942.21	0.00	15/11/91	22,626.59
WS87395	16,322.68	0.00	05/12/91	38,949.27
Payment	0.00	12,048.03	05/12/91	26,901.24
WS87706	2,318.12	0.00	14/12/91	29,219.36
WS88043	4,321.15	0.00	30/12/91	33,540.51
BALANCE DUE TO WHOLESALE SUPPLIERS				\$33,540.51

Remember if you pay within 30 days of invoice date
we allow 2% Discount.

topic

8

audit reports

Session 8.1 Unqualified Audit Report

Session 8.2 Partly Qualified Report

Session 8.3 Fully Qualified Report

SESSION 8.1

UNQUALIFIED AUDIT REPORT

Objective : To enable trainees to prepare a standard "unqualified" audit report.

Time : 1 1/2 to 2 hours.

Material : Copy or extract of relevant statutes.

Session Guide :

- 1) Ask trainees what the final product of the audit process is.

- The Auditor's Report.

All the work of the audit and all the costs in terms of both time and money, is represented by a few short sentences. This is especially the case where the auditor has found no material errors or uncertainties. His report will be "unqualified" and this can be considered to be a "standard" or "clean" report.

Large public companies often produce glossy annual reports that can be 20 or 30 pages long. If you can get hold of a copy of one of these, show it to the trainees. The auditor's report may take up less than half a page but if you examine the notes to the account the auditor's fee will be recorded and this can amount to millions of dollars.

As the report is short it is essential that it is correctly drawn up and should carry as much meaning as possible.

- 2) Referring back to topic 1, ask the trainees:

Q: Why are co-operatives audited?

- A: Because the law requires it.

Q: What are the objectives of co-operative auditing?

- A: Give the definition as arrived at by your trainees
(Topic 1, Session 1.2).

- 3) Ask the trainees to draft an audit report from the following information.

Audit: A.B.C. Insurance Co-operative Ltd.
Year End: 31 March 1992
Findings: No material errors or uncertainties
were found by the auditor.

You are bound to get a wide variety of "Auditor's Reports". The best report will probably be:

Clear: The reader will understand what it is saying.

Comprehensive: Will say what has been audited.

Concise: Short enough to keep the reader's attention.

Where there is nothing materially wrong in the accounts the auditor will give an "unqualified report". Where there is anything materially wrong then this must be explained and- a "qualified report" will be issued. For this reason a general rule for audit reports is "the less said, the better".

- 4) Much of the content of the auditor's report will depend on the relevant statutes of the country you are in.

Using the extract from The Republic of Auditor's Co-operative Act (given in the case study) as an example, find out if the trainees are familiar with the provisions contained in their own Co-operative Societies Act. You will need to be able to explain to trainees how the details of the statutes affect the auditor's report.

There are a number of general principles which should be followed and these can be illustrated by reference to the example given which should be amended to suit local laws.

Lead the trainees through the example given below (amended for local conditions). If you have an overhead projector the slide could be prepared in advance.

- All documents should have a heading which makes it clear what it is about and who it is addressed to. In the example given, the Registrar of Co-operatives appoints the auditor but the financial statements on which the auditor is reporting are to be represented to the members of the co-operative. Ideally the report should be addressed to the members who own the society.
- It is usual to start with the type of work which has been done and on what. For example:

"We have examined the financial statements for the year ended 31 March 1992."
- The statutes require that the auditor states whether proper accounting records have been kept and that the accounts agree with the records. The auditor should also note that the requirements of the statutes have been met.
- The auditor's opinion should be given a separate paragraph.
- The report must include the auditor's title and the date of signature.

AUDITOR'S REPORT TO THE MEMBERS OF:

A.B.C. CO-OPERATIVE LTD.

We have examined the financial statements for the year ended 31st March 1992.

Proper accounting records have been kept and the financial statements are in agreement with the records and

comply with the Co-operative Societies Act 1979.

In our opinion the financial statements give a true and fair view of the state of affairs of the co-operative as at 31st March 1992 and of the surplus/(deficit) for the year then ended.

(signed)

Head of Audit
Co-operative Department

Capital City
17th July 1992

-
- 5) Make up some more examples using actual co-operatives from the area and ask the trainees to practise writing "unqualified" reports.

Remind them to include:

- Heading
- The work undertaken (scope)
- Statutory requirements met
- The opinion
- Title of auditor
- Date of signature.

REPUBLIC OF AUDITIA
CO-OPERATIVE ACCOUNTING AND AUDITING STATUTES
CO-OPERATIVE SOCIETIES ACT 1979

Chapter 2

- 2.1 The Committee shall ensure that proper accounting records are kept at all times.
- 2.2 The Committee shall be responsible for the preparation of annual financial statements which shall be presented to the members at the Annual General Meeting.
- 2.3 These financial statements shall include:
- a. A Balance Sheet;
 - b. An Income and Expenditure Account.

Chapter 3

- 3.1 Co-operative Society financial statements shall be audited by a person appointed in writing by the Registrar of Co-operatives.
- 3.2 The authorised auditor shall have the power to require the production of any book, document or record relating to the affairs of the society.
- 3.3 The authorised auditor shall have the power to summon any officer, member or agent of the co-operative whom he believes can give material information regarding the affairs of the co-operative.
- 3.4 The auditor shall state whether proper accounting records have been kept.
- 3.5 The auditor shall state whether the financial records are in agreement with the accounting records.
- 3.6 The auditor shall express an opinion on the truth and fairness of the financial statements audited.

SESSION 8.2

PARTLY QUALIFIED AUDIT REPORT

Objective: To enable trainees to explain the circumstances under which a partly qualified report is issued and the wording required.

Time: 1 1/2 to 2 hours.

Material: Case Study "Hire or Buy Co-operative".

Session Guide:

- 1) In the previous session you went through the procedure of drawing up unqualified audit report. This is also known as a "clean" report, where the auditor was able to give a "true and fair" opinion.

In some cases the auditor is not able to give a "clean" report and this is known as a "qualified" report.

- 2) Ask the trainees if they can identify examples where the auditor would have to qualify his report.
 - Statutes not complied with;
 - Proper accounting records not kept;
 - Accounts not in agreement with the records (very rare as these can usually be brought up to date easily);
 - Part of the accounts may not show a true and fair view;
 - None of the accounts show a true and fair view.

Point out that there are cases where the auditor's opinion may not necessarily be the opinion of the management.

- 3) Consider an audit where the auditor has been unable to verify stock amounting to \$1,000. The storekeeper has

left the co-operative since the year-end and the auditor feels that the stock may be fictitious but has no proof. Do the trainees think they should qualify the accounts in the following situations?

- A. Surplus \$1,000 net assets \$10,000 and stock \$8,000.
- B. Surplus \$20,000 net assets \$200,000 stock \$80,000.
- C. Surplus \$100,000 net assets \$1,000,000 stock \$800,000.

In (a) the amount of stock which cannot be verified is material and the accounts should be qualified.

In (c) the amount is unlikely to have any effect on the users of the accounts. It would not be material. The auditor would still have to consider if proper records had been kept. If he was satisfied that apart from this isolated example they had, then no qualification would be necessary.

Example (b) would depend on local circumstances. The auditor's prime consideration must be - would the knowledge of this affect the users of the accounts? If they knew about the problem would they act any differently towards the co-operative?

- 4) Refer again to situation (a). Having decided to qualify the report the auditor has to choose the wording. As before it must be:

Clear, Comprehensive, Concise.

Ask the trainees how they think the information should be given in the report.

As with an unqualified report there will be a heading, and a comment on what has been audited. Depending on the statutes there may be a comment about proper accounting records.

This will be followed by a paragraph regarding the item of stock which could not be verified. For example:

"We have been unable to verify the existence of stock valued at \$1,000 at 31st March 1992 which is included as part of the total stock of \$8,000 in the balance sheet".

Should the auditor include "because the storekeeper concerned has left the co-operative"?

This would depend on circumstances but as it is more likely to cause suspicion than to provide clarity, it is probably not useful to the accounts user.

- 5) If this is the only material problem that the auditor encountered he would not qualify the whole of the accounts, only the part that refers to stock. Everything else is still fairly stated and the auditor would give a "true and fair" opinion on the rest of the accounts.
- 6) Ask the trainees if the example given (point 4 above) is one of uncertainty or disagreement?

Presumably the auditor is disagreeing with the management's interpretation of the situation, but his disagreement is caused by uncertainty.

Where there is uncertainty, the auditor is unable to give an opinion on this specific transaction. He doesn't have sufficient information to say whether it is true or false.

If he could be sure that the stock was fictitious he would say the accounts do not give a true and fair view of this transaction.

The difference between uncertainty and disagreement is important as it alters the wording of the auditor's opinion.

Where there is uncertainty, the opinion paragraph would commence:

- "Subject to the above, in our opinion the accounts give a true and fair view....."

Where there is disagreement, the opinion paragraph would commence:

- "Except for the above, in our opinion the accounts give a true and fair view....."

- 7) Divide the trainees into working groups and hand out the work sheet "Hire or Buy Co-operative".

Ask the trainees to prepare audit reports for each of the situations given. The information should be considered one point at a time and a report written for each circumstances.

Discuss with the trainees' their answers and try to identify the explanations which best fit the requirements of being:

Clear, Comprehensive, Concise.

The trainees reports should fit the following:

- | | |
|--------------------------|------------------------------|
| a) Not material | - No qualification |
| b) Material uncertainty | - "Subject to" qualification |
| c) Material disagreement | - "Except for" qualification |
| d) Material disagreement | - "Except for" qualification |
| e) Material uncertainty | - "Subject to" qualification |
- 8) Some of the trainees may recognise item (e) as a "going concern" qualification. This means that the auditor feels that the co-operative may not be a going concern much longer!

It is common in some countries for co-operatives to be supported financially by one organisation (often the government). The auditor must consider if the co-operative could continue operations if the funding was withdrawn, but he would only qualify the accounts if he could not get assurance that the funding would be avail-

able for at least one year.

Ask the trainees if they know of any examples of co-operatives which fall into this category.

- 9) Stress to the trainees that the wording of a qualification is extremely important. It must not cause undue anxiety amongst the members or creditors but must simply state the facts of the situation.

This is especially true in the case of "going concern" qualifications as these have a tendency to be self-fulfilling.

HIRE OR BUY CO-OPERATIVE

Turnover: \$300,000
Surplus: \$36,000
Net Assets: \$180,000
Year End: 31st March 1992

- a) A debtor who owed \$500 died on 28 February 1992. The debt has not been recovered.
- b) A fire in the accounts department destroyed cash sales records said to amount to \$18,400. Audit procedures have been unable to verify this amount.
- c) The co-operative includes all receipts on income even though members pay rental for television sets up to one year in advance. The board refuses to change its policy which you consider wrong. You estimate prepaid rentals at 31st March as \$23,000.
- d) Buildings have been revalued by the manager at \$80,000 (original cost \$30,000). You were surprised at the increase and requested the management to engage an independent qualified valuer who assessed the current value of the buildings at \$52,000. The board does not agree with this valuation.
- e) The balance sheet contains a loan of \$200,000 which is due to be repaid on 30th June 1992. The bank has indicated that because of the government's credit squeeze, they are unwilling to renew the loan. Alternative financing has not been found and you feel that without a new source of finance the co-operative may be forced into liquidation.

Assignment

For each of the above circumstances would you consider a qualification necessary and if so, what form of explanation and audit opinion would you give?

SESSION 8.3

FULLY QUALIFIED AUDIT REPORT

Objective : To enable trainees to identify situations where it is not possible to give a "true and fair" opinion on any of the financial statements.

Time : 1 to 1 1/2 hours.

Material : Case study "Runnawae Groundnut Marketing Co-operative Society".

Session Guide :

- 1) In the previous session you discussed the importance of materiality when considering qualifying accounts. If there is a material item about which the auditor is uncertain or disagrees with, then he will qualify the accounts in relation to that item only.

Remind the trainees that items in the accounts are related to each other. A change in stock values will affect both the balance sheet and the profit and loss account, as would an increase in provision for bad debts. Ask for some more examples.

Because of this relationship there is a point where an item or items become so important that it affects the whole of the accounts. If these items cannot be settled then the whole of the financial statements may be meaningless.

- 2) Ask the trainees if they can think of any situations where items are so important that they would make it impossible for the auditor to give a true and fair opinion on the accounts as a whole.

As before, these will fall into two categories:

Uncertainty

- Records missing (Fire, flood, computer breakdown etc .)
- Doubtful outcome of contracts or recovery of major debts
- Continued liquidity problems
- Incompetent management

Disagreement

- Inappropriate accounting policies;
- Fraudulent practices.

Where a matter is so material that it could make the account meaningless as a whole - this is known as being fundamental .

Matters that are fundamental are extremely rare!

- 3) As before, there is a difference between uncertainty and disagreement. Ask the trainees if they can explain how this difference affects the audit report.

Uncertainty - Accounts may not show a true and fair view

Disagreement - Accounts do not show a true and fair view.

The auditing terminology for these in a report is:

Uncertainty - "We are unable to form an opinion on the truth and fairness of the financial statements".

Disagreement - "In our opinion the financial statements do not give a true and fair view....."

- 4) As with any qualification, one that is based on a fundamental matter must be explained in the audit report. It is also common for the auditor to state the items that he has been able to confirm on an individual basis (if

any), in order to provide some information for the accounts user.

- 5) Hand out the case study "Runnawae Groundnut Marketing Co-operative Society" and ask the trainees to attempt to prepare the auditor's report.

Remind them that the report should contain the following:

- Heading
- Facts of the qualification
- Title
- Work done
- Opinion
- Date

Discuss the trainees' reports and compare them to the example given below. This assumes that there is a note to the accounts explaining the situation and that estimates have been used in the preparation of the accounts.

Students should recognise that the reason for the qualification is the lack of records and that the disappearance of the manager is only a secondary matter.

AUDITORS'S REPORT TO THE MEMBERS OF
RUNNAWAE GROUNDNUT MARKETING CO-OPERATIVE SOCIETY

We have examined the financial statement for the year ended 30th June 1990 which, with the exception of the matter mentioned below, comply with the Co-operative Societies Act 1979.

During the year a fire occurred at the society which destroyed most of the source documents. The manager of the society was not available to provide information or explanations regarding the transactions of the society. As a result the accounting records were incomplete.

We are satisfied that the figures given for groundnut sales, stock, balance due to Co-operative Union and balance due to Co-operative Bank are fairly stated.

In view of the above, we are unable to give an opinion on the truth and fairness of the state of affairs of the co-operative as at 30th June 1991 or of the deficit for the year then ended.

(signed)

Head of Audit
Co-operative Department

Capital City
17th July 1992

RUNNAWAE GROUNDNUT MARKETING CO-OPERATIVE SOCIETY

The manager of the Runnawae G.M.C.S. disappeared in the middle of the marketing season shortly after a cash delivery of \$50,000 was made to the society.

An investigation was carried out by the staff from the Co-operative Union who found that most of the source documents had been destroyed in a fire which occurred shortly before the manager left.

The Union staff prepared accounts which identified possible cash shortages of \$72,000 and unquantified stock losses. Due to the missing records the accounts necessarily included a number of estimates.

After auditing the available information the auditors were only able, through physical counting, reconciliation and contacting external independent sources, to verify the following:

o Groundnut deliveries to Nation Depot	1,312 tonnes
o Value of deliveries	\$295,200
o Stock at 30th June 1991	\$21,300
o Balance on Co-op. Union account	\$86,457 (due to Union)
o Balance on Co-op. Bank account	\$236 (overdrawn)

Assignment

Prepare a suitable audit report.

topic

8

audit reports

Session 8.1 Unqualified Audit Report

Session 8.2 Partly Qualified Report

Session 8.3 Fully Qualified Report

SESSION 9.1

CONTENTS OF REPORTS TO MANAGEMENT

Objective: To enable trainees write reports to management after an audit.

Time: 3 to 4 hours (plan to have a break during the session).

Material: Report to Management;
Points for consideration for management report.

Session Guide:

- 1) Explain to the trainees that generally, the auditor is in a unique position to study the operations of the co-op and it would be a waste of human resources if he did not use this position to provide constructive advice to the committee and management.

What is the value to the committee and management in terms of operating the co-operative?

- Very little. The official report is to reassure the accounts users and, in particular, the members, that the financial affairs of the society are in good order.

From this it can be seen that a great deal of time and effort goes into the audit but that the official output is limited.

- 2) Ask if the trainees can think of any other group of people who have the same opportunity and time to study the operations of the co-operative.
 - Possibly there will be co-operative inspectors but the time they are able to spend at each co-operative will be limited.

- Consultants may be called in for specific assignments but the scope of their work is limited by their terms of reference.

3) Ask the trainees what they understand by the term "Report to Management".

This may be known by a number of other names such as "Post Audit Letter", "Letter of Weaknesses", "Management Letter", "Audit Comments" etc. These should all provide the same thing - advice regarding the operations and management of the co-operative.

Ask what items might be included in a Report to Management. These could fall under the following headings:

- Areas of weakness in the accounting systems.
- Areas of non-compliance with accounting systems.
- Items which although not material at present, could be in the future.
- Possible improvements in management efficiency or effectiveness.
- Possible improvements in the use of resources.
- Cost control or reduction measures.
- Interpretation and analysis of financial information.
- Possible improvements in the presentation of the financial statements.

Try to ensure that you have at least one example of each of the above.

4) Hand out the Report to Management prepared by U.R. Crupt and discuss what is wrong with it. Is it likely to be of help to management? Will it serve to increase management's confidence in the auditor's ability?

Cover the following:

- No proper heading (who is it addressed to?);
- No structure report;

- Lacks detail
- Does not give the consequences of the weaknesses
- Lacks recommendations
- Contains irrelevances
- Contains gratuitously disparaging remarks
- Does not consider cost versus benefit
- Timing (it is too late to be of any use)
- Does not give management the chance to reply

The report is unlikely to help management and the auditor is not likely to be welcomed back as someone who will provide a positive input.

Discuss who the report should be addressed to. Usually it should be to the chief implementer of the co-operative's policy. In large societies this is likely to be the General Manager whereas in smaller societies it is likely to be the Chairman of the board.

- 5) Ask the trainees to rewrite the report in a manner that will be helpful to the committee and management of the co-operative.

They should omit irrelevancies and trivialities. Encourage the student to use their imagination to think up examples that could fit the given circumstances and provide recommendations for improvement.

Before the report is finalised it is recommended that the auditor discusses a draft report with the management in order to eliminate trivialities or misunderstandings.

- 6) Trainees must not confuse the contents of the auditor's report on the financial statements with that of a Report to Management.

It is important that trainees are aware that by including an item in the Report to Management this does not absolve the auditor from the responsibility of qualify-

ing the audit report in respect of material uncertainties or differences.

In practice, Reports to Management concentrate on items which the auditor has not considered material in relation to the accounts as a whole but which are still significant and could be improved to the benefit of the co-operative.

Although it is necessary to say what is wrong, it is more important to say how it can be put right.

The Report to Management is an important part of auditing and should not be ignored. If it is properly compiled it will increase the management's confidence in the abilities of the auditor. He will be welcomed back in the future as someone who can make a positive contribution to the co-operative, rather than someone who is simply performing a statutory duty and is only concerned with finding faults.

- 7) The remainder of this session is taken up by study and discussion of the Calypso Consumer Co-operative.

The purpose is to allow trainees to develop their abilities in assessing weaknesses in control systems and in putting forward recommendations for improvement in a manner that will be taken up by the management.

- 8) Divide the trainees into small working groups and hand out the case study. Explain that the audit has been completed and as no material uncertainties or differences have been found, a "true and fair" audit opinion will be given.

The senior auditor has gone through the file and listed those matters which he thinks the head of audit might include in the Report to Management. He has included all weaknesses and errors found even though he knows some of these are trivial.

Remind the trainees that the following should be included:

- Heading and date;
- Introduction;
- Description of weakness and possible consequences;
- Recommendation for improvement;
- Opportunity for management to reply;
- Offer of further assistance if required.

- 9) Allow up to one and a half hours for the trainees to study the information and to prepare draft reports. Discuss the trainees reports in relation to the example given.

Remember - There is no standard format of Report to Management. However, any format that is used should give the management the opportunity to reply.

Co-operative Department
Audit Section
Government Buildings
Capital City.

15 September 1991

The General Manager
Calypso Consumer Co-operative Ltd.
High Street
Anytown.

Dear Sir,

AUDITOR'S REPORT TO MANAGEMENT

Staff from the Audit Section have recently completed the audit of your co-operative for the year ended 30th June 1991. During the course of the audit a number of weaknesses in the control systems and operations of the co-operative were noted. The purpose of this letter is to inform you of these weaknesses and to suggest possible improvements that could be made to further secure the assets and enhance the efficiency of the co-operative. I would point out that our examination has not necessarily highlighted all the shortcomings in the co-operative's system.

The attached schedule sets out the weaknesses noted, together with recommendations for improvement. I would be pleased to discuss these matters with, and receive comments from yourself and management.

I would be glad to supply any further information or assistance which you may require, and would be pleased to receive details of any action taken or proposed to be taken.

Yours faithfully,

(Ima Nakowntant)
Head of Audit

cc. Registrar of Co-operative Societies.

AUDITOR'S REPORT TO MANAGEMENT

SCHEDULE

WEAKNESS	RECOMMENDATION
1. <u>Computerised System</u>	
IA. The arrangements for storing computer software are inadequate. In the event of fire or other natural disaster much of the financial records of the co-operative could be lost. Rebuilding the records would be a difficult and expensive task.	Due to the technical nature of computer systems, a computer specialist should be asked to advise on improving the system.
1B. Insufficient use is being made of the computer's facilities. Management is not receiving all information available to assist them in running the co-operative.	The co-operative should work towards the production of monthly accounts.
1C. The implementation of the computerised system has created ,3 new staff posts, which has contributed to an increase in staff costs. The workload of the accounts department had been reduced but there has been no consequent reduction in staff.	A staff review should be made of the accounts department, with the objective of reducing costs.
2. <u>Fixed Assets</u>	
2A. Buildings are currently depreciated at 10% p.a. which is considered to be excessive in relation to the useful lives of the assets. The charge to the profit and loss accounts is therefore higher than necessary.	The society's depreciation policies should be revised based on the expected useful life of the assets.
2B. No record is kept of items of furniture and equipment with a value less than \$250. Consumption of these items appears excessive.	Issuing controls of these items should be strengthened.

AUDITOR'S REPORT TO MANAGEMENT

SCHEDULE (continued)

WEAKNESS	RECOMMENDATION
<p>3. <u>Current Assets</u></p>	
<p>3A. The level of spoilt goods rose by 24% during the year. The fixed pricing policy prohibits price reductions on items nearing their expiry date.</p>	<p>The policy should be revised to allow the manager to reduce the price of perishable goods when they are nearing the expiry date.</p>
<p>3B. The average period for the recovery of trade debts has increased by 12% and the requirement to provide for doubtful debts has also increased. There is no set policy for allowing credit to customers. This may increase the incidence of bad debts.</p>	<p>A formal credit policy should be prepared for approval by the Board. The policy should set maximum limits and no further credit should be allowed where there are overdue balances. The production of an aged debtors list will assist in debt recovery.</p>
<p>3C. At times during the year substantial balances build up in the society's bank account. The co-operative is losing an opportunity to realise additional income.</p>	<p>Facilities exist in the banking sector for investing excess funds on a short-term basis.</p> <p>A deposit account should be opened at the bank and excess funds should be placed in it. The management should pay closer attention to the short term cash flow requirements of the co-operative.</p>
<p>4. <u>Current Liabilities</u></p>	
<p>4A. The level of members' deposits fell by 50% which reduced funds available for use by the co-operative. The Byelaws require a fixed interest rate of 5% to be paid on deposits whereas the banks are currently paying 10%.</p>	<p>A proposal to amend the Byelaws should be presented at the AGM. The amendment should allow interest to be paid at rates comparable to those available in the banking sector.</p>

REPORT TO MANAGEMENT

During our audit for the year ended 31st December 1990 we found the following mistakes which you must put right.

1. The cash did not balance by \$2.03 (surplus).
2. We did not count stock at Wayout store because your vehicle broke down.
3. The fixed asset register was not up to date.
4. Two invoices were paid although they did not add up properly;
5. Cash and bank reconciliations are only prepared when the cashier has time - which is not very often.
6. The board met twice in November but did not meet in December. The Byelaws state that monthly meetings should be held.
7. Mr. Tickit, the Internal Auditor, is lazy and unhelpful. He made disparaging remarks about our audit and he should be dismissed.
8. The wages clerk is very busy at the end of the month. You should employ someone to help her.
9. The controls over ordering and payments are weak.
10. The auditors were not offered any food or refreshments during their visit.

U.R. Crupt
Senior Auditor
Co-operative Audit.

12 January 1992

Assignment

Consider if this report is likely to:

- a) Be of help to management;
- b) Increase management's confidence in the ability of the auditor.

Co-operative: Calypso C.C. Prepared by: A. Senior
Year End 30 June 1991 Date 14 Sept. 1991

Subject Points for consideration for
Management Report.

Systems Weaknesses

1. Only one back-up disk is kept for the computer system. The disks store the majority of the co-operative's financial information. Back-up disk is stored beside the original.
2. Accounts are prepared quarterly as before but the computer has facility for monthly accounts.
3. No policy for allowing credit to customers. This is done solely at manager's discretion.
4. Policy is not to capitalise furniture and equipment purchases under \$250. No register is kept of these items and consumption/use appears excessively high.

Compliance Weaknesses

1. Filing of computer output is not up to date.
2. One invoice (sample size 50) was not initialled as proof of calculations having been checked.
3. Debtors aging analysis is not produced although computer has this facility.

Substantive Test Weaknesses

1. Depreciation of buildings is calculated at 10% p.a. This does not reflect useful life (estimated at 25 - 50 years).
2. A member of staff left without repaying a loan \$25.00.

Analytical Review

1. Debtors turnover ratio increased by 12%. Doubtful debt provision also increased by similar margin.
2. Substantial balances kept on current account at times during the year. No interest earned as co-operative does not operate deposit account.

Co-operative: Calypso C.C.
Year End 30 June 1991

Prepared by: A. Senior
Date 14 Sept. 1991

Subject Points for consideration for
Management Report.

Analytical Review (continued)

3. Staff costs increased by 22% and total of 5 new posts. 3 were created by new computer department. Accounts department workload reduced but uses the same number of staff as before.
 4. Level of spoilt stock rose by 24%. New shop opened nearby which at times undercut CCC's prices on perishable goods. CCC operate fixed pricing policy of cost plus 25% and manager could not reduce prices either to compete or to sell off items nearing expiry dates.
 5. Members' deposits fell by 50%. Interest payable on Members' deposits by the co-operative, is fixed by the by-laws at 5% and this does not compete with current average bank rates of 10%.
-

Assignment

Prepare a draft Report to Management based on the information given above.

topic

10

special audits

Session 10.1 Computerised Systems

Session 10.2 Investigations

Session 10.3 Management Audit

SESSION 10.1

AUDITING OF COMPUTERISED SYSTEMS

Objective : To enable trainees to follow the approach required when auditing co-operatives which make use of computers.

Time : 1 1/2 to 2 hours.

Material : Case study "The Tip-Top Co-operative".

Session Guide :

- 1) Computers are no longer restricted to large organisations; due to their usefulness and reducing prices are being used in relatively small businesses. This has significantly altered the manner in which accounting records of many businesses, including co-operatives, are recorded.

Auditing in a computer environment is often seen as a specialised aspect of the profession but as it becomes the norm for co-operatives to make use of computers, auditors will have to adapt to this change.

- 2) How are the auditor's duties changed where the co-operative maintains the majority of its financial records on a computer?
 - They do not change!

The auditor still has to determine that the records:

- are complete and accurate;
- form a suitable basis which will allow the production of "true and fair" accounts.

- 3) What are the problems which auditors may encounter when dealing with societies which use computers?

- Complexity of systems which require specialised knowledge.
- Lack of visible evidence (although most computers produce more paper than management can deal with).
- Computer information may only be retained for limited time periods.
- Data may be "overwritten" if the wrong disk is used.
- A programme error will be repeated continuously if it is not noticed.
- Use of incomprehensible computer jargon.
- Breakdowns, fire, floods etc.
- Sabotage or "virus" programmes which spoil or jam everything.

Ask the trainees for suggestions as to how these problems can be overcome.

- 4) As the audit objectives are unchanged, the basic audit approach will be unchanged. It will however, be necessary to alter the details of the approach.

The audit places emphasis on the quality and operation of internal controls. Discuss with the trainees and explain why the following controls should exist in a computer environment and obtain examples of each.

Administrative Controls

- Division of responsibilities (e.g. those who are involved in systems development should be separate from those operating the computer).
- Staff discipline.
- Security of hardware and software.
- Standby arrangement in case of breakdown.

System Controls

- Documentation procedures and manuals.
- Adequate amendment procedures.
- Adequate testing - especially of new programmes.

Input Controls

- All input is authorised.
- Use of correct files.
- Use of control totals.
- Control over rejection and re-input of data.
- Master File controls.

Output Controls

- Verification of output.
- Exception reporting.
- Storage of output.

As computer processing is recognised as being much more reliable (when properly controlled) than manual records, the auditor's examination and testing of internal control is increased.

- 5) The process of assessing weaknesses and performing compliance tests will be similar to that of manual records but substantive testing will be different.

The auditor has to decide whether he will audit "Round" the Computer or "Through" the Computer.

Discuss what these terms mean and the implications (including time and cost) of each.

Round the computer

Selecting input records, performing the relevant calculations manually and comparing the results with the computer's output.

Through the computer

Using data prepared beforehand (often in the form of a specialised programme known as an Audit Pack), running this through the computer and comparing the results with those expected. This data will include deliberately invalid items to ensure that the correct reaction is obtained.

The factors which should be considered when making the decision whether to audit "through" or "round" the computer will-include:

- complexity of systems;
- availability/cost of computer "audit" packs;
- reliability of existing controls;
- computer time availability.

- 6) Hand out the case study and ask the trainees to prepare a draft of a reply to Mr. Topmun.

Discuss the students' answers in relation to the controls mentioned in Point 4. above and go over any controls which do not seem to have been fully understood.

Try to ensure that the examples which the trainees have given are relevant and cost efficient.

- 7) The trainees should not be frightened or overawed by computers but should see them as a tool which is not only of great benefit to management but can also be useful to the auditor.

Ask how computers can be used to make an audit more efficient.

- Select samples for testing.
- Select exceptional items for scrutiny.
- Provide analysis for analytical review.
- Carry out complex calculations.

- 8) Explain to the trainees that as the use of computers increase worldwide, auditors will in the future be expected to be able to understand and use computer systems as part of their normal duties.

THE TIP-TOP CO-OPERATIVE

Mr. Topmun, the Chief Accountant of the Tip-Top Co-operative, is considering buying a computer on which he wants to maintain the co-operative's stock records.

The co-operative keeps up to 300 stock lines and has an average stock turnover ratio of 90 days. Because he considers the stock as a complex item, Mr. Topmun does not want to integrate the stock system with any other computerised system which may be installed in the future. He feels that he does not need to set up a special computer department just to run the stock records.

Although he has no experience of computers he is aware that good controls are essential if the investment is to be a success. He has written to you asking for advise whether it will be possible to have adequate controls without setting up a separate computer department.

Assignment

Draft a letter in reply to Mr. Topmun outlining a suitable control system and give examples of how the controls should be operated in practice.

SESSION 10.2

INVESTIGATIONS

Objective: To enable trainees to recognise and apply the special features of an investigation.

Time: 1 1/2 to 2 hours.

Material: Case Study "Creditworthy Fishermen's Co-operative".

Session Guide:

- 1) Ask the trainees how they think an investigation differs from auditing.
 - It is an enquiry for a specific purpose. The scope is usually much smaller than that of auditing and should be clearly defined.
 - Although the scope is smaller, greater detail is required.
 - Materiality is not usually a consideration. The person conducting an investigation wants to know exactly what has happened. He needs facts rather than an opinion.

- 2) In what ways are investigations similar to audits?
 - They are both forms of enquiry (an audit is a form of investigation).
 - They both require planning, testing, review and reporting.
 - They use the same techniques of inspection, observation, enquiry and calculation.

- 3) Why are auditors in an ideal position to carry out investigations?
 - They are independent and have integrity.

- They are qualified and skilled.
- They are experienced and have a knowledge of the co-operative and similar societies.
- Their report is likely to be acceptable to all parties involved.

4) There are two main types of investigation that co-operative auditors may be asked to carry out. Ask the trainees for examples of investigations and fit these into the following:

- Investigating something that has gone wrong (usually suspected fraud).
- Investigation into a specific areas of operations of a co-operative (e.g. the Transport Department).

Discuss the examples given by the trainees and try to define what it is that the auditor is being asked to find out.

All investigations should be structured around:

"What does the investigator want to know"?

This will determine the scope of the investigation and it is important that clear instructions are received before any work starts.

5) Hand out the case study "Creditworthy Fishermen's Co-operative" and give the trainees 20 minutes to study it and to make notes on the three assignments set.

Ask "What is it the investigator is required to find out?"

- Are the loan balances correctly recorded?
- If not, why not?
- Is there any money missing from loan repayments?

He is not at this stage asked if any other receipt are missing or if improper payments have been made. This may follow on later, depending on the results obtained.

What do the trainees think might have gone wrong?

- Possibly nothing, only that the records are not up to date.
- The chairman may have been pocketing the loan repayments.
- The members may be trying to take advantage of a confused situation.
- The manager may be trying to cover up previous manipulations.
- There may be collusion between some of the parties involved.

It is necessary that the investigator should have an idea of what may have gone wrong. However, it is essential that he does not commence the investigation with a preset idea of what has gone wrong.

Discuss the trainees' responses to the assignments set.

- a) The first part deals with planning. How many investigators, where when, for how long etc. This will require background information as the number of loans and amounts, which should be available from the audit files or may require a preliminary visit to the co-operative.

One of the considerations must be the time period to be investigated. Should it only be the period when the manager was ill or should the investigator go back further, perhaps to the last audit?

- b) Records will depend on the local circumstances but presumably will include:
 - Receipts
 - Loan records
 - Members' passbooks or loan books
 - Cash book
 - Bank deposit records

The list is not very long and the scope of the investigation in terms of records is fairly limited.

A significant amount of time must be spent making enquiries and discussing the matter with those involved in order to follow up the results of the test.

c) Report contents should include:

- Heading;
- Summary of objectives (terms of reference);
- Scope (areas covered and time period);
- Outline of work undertaken (methodology used);
- Information obtained (keep to the facts!);
- Conclusion.

An investigation does not usually include recommendations unless these are specifically requested by the person who requests the investigation.

6. If any of the trainees have taken part in an investigation ask them to describe their experience to the group. Ask them specific questions such as:

- Were the instructions clear?
- Was a satisfactory result achieved?
- If not, what do they think went wrong and how could this have been improved?

CREDITWORTHY FISHERMEN'S CO-OPERATIVE

The Creditworthy Fishermen's Co-operative makes loans to members for the purchase of nets, engines and other fishing gear. Loans are given to members who have made regular savings and are repaid in monthly instalments over one year.

The manager of the society was ill for three months and during this time the chairman of the co-operative was collecting loan repayments. On the manager's return to work he sent a report to the Director of Co-operatives containing the following:

- The loan records were not up to date.
- Loan repayments were much lower than he had expected.
- Some members say they have made repayments but are unable to produce receipts;
- The chairman has not given a clear explanation of what has happened in the manager's absence;
- The manager does not want to argue with the chairman as he is ultimately the manager's employer.

The Director of Co-operatives has asked you to investigate the matter.

Assignment

Make notes on:

- a) How you would proceed with the investigation
- b) What records you would look at
- c) What headings you would expect to include in your report

SESSION 10.3

MANAGEMENT AUDIT

Objective: To enable trainees to interpret and apply the concepts of Management Auditing.

Time: 2 to 2 1/2 hours.

Material: Case study "Nationwide Transport Co-operative".

Session Guide:

- 1) Trainees will be aware that statutory auditing has in the past been a rather narrow profession, confining itself to matters laid down by law or society byelaws.

Critics may say that the use of highly skilled and intelligent staff to review other peoples' accounting records is a waste of resources.

Discuss with the trainees how this type of argument can be countered.

- Without effective external examination by sufficiently skilled and independent people it would be difficult for co-operatives to build up the necessary confidence and support to operate in a commercial environment.
- The audit can make a considerable contribution to the efficient operations of the co-operative through reporting weaknesses and through suggesting improvements.

The Report to Management has become almost universal in the professional auditing firms and this is being expanded into a new field known as "Management Auditing".

Management Auditing bridges the gap between traditional

auditing and management consultancy. Management auditing goes further than items covered by the Report to Management by examining the objectives of the co-operative and the manner in which policies are carried out by management in order to meet the objectives.

Stress to the trainees that there are two parts:

- The objective and policies. Do they meet the needs of the members?
 - The efficiency of execution of the policies.
- 2) Ask the trainees what areas of a co-operative's operations might be subject to Management Audit.
- Basically it is any area where management either set or execute policy decisions.

Cover the following and find at least one example for each where improvements could be made which would ultimately benefit the members.

- Suitability of objectives (do they meet the members' needs?)
- Are objectives complementary (could there be a clash of interest?)
- Relationship with members (is management concerned with the members' opinion?)
- Relationship with outsiders (are others confident about the functioning of the co-operative?)
- Staff morale (are they suitably motivated to perform in the best interests of the members)
- Quality of staff (are they capable of doing their jobs?)
- Organisation control (is the management structure effective?)
- Financial control (does the co-operative use modern methods?)
- Value for money (have the best decisions been taken in terms of efficiency and effectiveness of operations?)

- Management techniques (does the co-operative use modern methods?)
- Specialists (do they call in qualified people to solve technical problems?)
- Corruption (does it exist/is it condoned by management?)
- Social attitude (is the co-operative concerned with matters such as the employment of minorities?)
- Environment (is the co-operatives concerned with matters such as desertification and pollution control?)

- 3) Many of these items are outside the scope of ordinary auditing but there are few people who have the same opportunity to study the complete operations of a co-operative in the manner that auditors have.

Management consultants are usually only called in when it is apparent that there is a problem which must be solved. However, boards and management are often unaware that a satisfactory performance might be improved by changes in, or implementation of, policy. They may not recognise that a problem exists at all even if they do, it is all too easy to say the problem is outside their control.

A statement such as "the deficits of the past three years have been caused by government policy" should not deter the Management Auditor from a thorough examination of all management activities. The "government policy" excuse may be true but is often used to cover operations which are inefficient and not geared to the needs of the members.

- 4) Discuss the case study with the trainees and try to get them to put forward suggestions as to:
- What might be the problem?
 - What would they examine to verify their theories?
 - What questions might they put to board members, mana-

gement, employees and ordinary members?

The basic problem would seem to be that the co-operative is stagnating. The trainees should be encouraged to say why this might be and what changes might be made to reverse the trend.

- S) Auditing like any other profession evolves over time. As the focus of auditing moves from solely investigating the financial affairs of a society, to include the provision of advice to management, Management Auditing will become more widely appreciated and used.

The auditor will be expected to acquire new skills if he is to effectively expand the scope of his work into the various aspects of co-operative management.

Ask the trainees in which areas of management might additional training be required before an auditor can expect to be able to effectively assess and advise.

These might include:

- Organisational structures;
- Personnel management;
- Management styles;
- Production and marketing techniques.

- 6) As a concluding statement to the trainees course, explain that most professional accounting bodies of the world are well aware of the need for auditors to have a wide range of business skills and often require students to have a business related degree before they will accept an application for registration. The need for increased management skills is likely to spread throughout the auditing profession in the future as the benefits of Management Auditing become more widely accepted.

NATIONWIDE TRANSPORT CO-OPERATIVE

The Registrar of Co-operatives has been reviewing the draft accounts of Nationwide Transport Co-operative and has noted that surpluses have slipped over the past three years. The co-operative is still trading profitably but bonuses to members have not kept pace with inflation.

On reviewing the files available to him, the Registrar has obtained the following information which he believes might be relevant and indicates that there could be a management problem at the co-operative.

- Membership has remained static during the period.
- The attendance of members at the A.G.M. has fallen significantly and at the last meeting there was some difficulty in finding sufficient members willing to take up positions on the committee.
- There have been no significant changes in managerial or financial systems in the past three years.
- There has been a high turnover of staff, especially in the middle management range.
- Capital investment is declining.
- Market share has fallen by 10% in a market that has increased in total by 5% per annum.

The head of audit recently explained to the Registrar how his staff could be used effectively to carry out management audits as an extension of their ordinary auditing duties. The objective being to improve management performance through a review of policy and operations.

The Registrar is not sure that the scope of the auditor's work can be expanded in this manner but feels that this could be an ideal opportunity to experiment. He asks the head of audit to proceed with a management audit in addition to the statutory work they were about to commence.

Assignment

If you were the auditor of "Nationwide Transport Co-operative", what matters would you investigate as part of the management audit?

topic

11

action commitment

Session 11.1 Action Commitment

SESSION 11.1

ACTION COMMITMENT

Objective: To enable trainees to apply what they have learned in this course to their work.

Time: Depending on the number of trainees, a minimum of twenty minutes each.

Material: Action Commitment forms (two copies should be distributed to each trainee at least two or three days before this session).

Session Guide:

- 1) Remind trainees of the difference between the classroom experience they are just completing and the reality of co-operative audit. The two may very easily become unrelated. The ambition of this course, however, is that trainees should apply what they have learned in the classroom to the audit of co-operative societies.
- 2) Trainees should be warned at the beginning of the course that they will be required at the end to present a plan of action whereby they propose to implement in their work something which they have learned on the course. They should be continually reminded of this during the course, and encouraged to relate what they are learning to their own experience.
- 3) Each trainee should be given two copies of the action commitment form two to three days before this session in order to allow them time to think about what they propose to do, and to write it down in duplicate. Trainees who work in conjunction with others on the course should also discuss their plans with them, to ensure that they are co-ordinated with one another and that they do not duplicate or conflict.

When distributing the action commitment form, stress that trainees must present a plan which they actually have a good chance of implementing themselves, and which does not depend on impossibly ambitious proposals to change the view of their superiors, or the total administrative system within which they work. Some participants may feel that it is impossible to implement any change, since they are so constrained by others. Stress that change in any organisation does not only come from the top, and that a training course of this type is a total waste of time and resources if it does not lead to some changes.

Stress also that the action commitment need not, and indeed should not, be over ambitious. If trainees commit themselves to implementing even one modest change, which is wholly within their own capacity, this will be some improvement and should also lead to application of other lessons which they have learned on the course.

4) Trainees should complete the forms, briefly, in duplicate, in order to keep one for themselves and to hand the other to the instructor. Stress that you will follow up the commitments, personally or through correspondence, in order to ensure that trainees have in fact attempted to implement their plans. Stress that the objectives of this follow-up are as follows:

- To remind, assist and encourage trainees to make a serious attempt to implement what they plan.
- To evaluate the training programme itself and not the participants, since it is the fault of the instructors and/or the course material if trainees are unable to make use of it in the field.

5) When handing out the action commitment form, go through the headings, stress that two or three lines are all that is required under each, and explain in particular the last two items:

- Trainees must recognise that they will have to think at least as much about how they are to introduce change as about what change they are to introduce.

Superior officials, colleagues in the same position or subordinates all have to be persuaded and agree to the change, as do officials (in many cases) of the co-operatives to be audited. It may be possible for trainees, particularly those of more senior level, to "order" people to do things, but they will not do them effectively if they do not believe in them. Sending a memorandum or making a written report is unlikely to persuade people to change.

- The final item on the form requires trainees to commit themselves to a specific, measurable target by six months at most after the end of the course. This ensures that the action commitments are concrete and specific, rather than vague commitments to general improvement. A commitment to "improve the standards of co-operative audit" may be sincere, but nobody, including the trainee who commits himself to it, can possibly state specifically that it has been achieved. "To train my subordinates on how to prepare clear, concise and accurate audit reports and to ensure that their reports meet these criteria within six months" is more modest, but it is measurable.

- 6) The instructor's copies of the action commitment forms should be collected from trainees shortly before this session, in order to allow them time to incorporate what ever they may have learned from all the previous sessions. If possible, a brief summary of all the action commitments should be prepared and distributed to every trainee, at the beginning of this session, in order to improve the quality of the analysis and advice which they offer to their fellow trainees.

It may also be possible to combine this session with the

official closing ceremony, if such a ceremony is to be held. The presence of a senior invited guest will underline the seriousness of the trainees' action commitment presentations, and will also be a means of informing the guest about the concerns trainees may have and ways in which he can improve the situation from his level.

- 7) Allow each trainee up to ten minutes to make a brief presentation of his or her action commitment. If time and facilities allow, they should have been given the opportunity to prepare flip charts, ohp transparencies or other means of explaining what they propose to the rest of their colleagues.

Stress that this presentation can be a "rehearsal" for any presentation that trainees will wish to make to their colleagues on their return home; trainees should aim to be brief, clear and persuasive.

After the ten minute presentation, allow a further ten minutes, or more time if this is available, for other trainees to ask questions, make suggestions and generally attempt to assist and improve their colleague's chances of success.

Attempt to elicit possibilities of inter-departmental-conflict or co-operation, and ensure that trainees use this session as an opportunity for assisting one another rather than pointing out the reasons why their action commitment may not succeed.

Summarise the bare details of each action commitment on the chalkboard. At the end of the session conclude the programme by going through the list showing what a significant improvement will be achieved in co-operative audit and control if all plans are implemented, and stress that the training programme only really begins when the formal classroom sessions have finished; the seeds have been planted, but the programme will only have been a success if they germinate and the fruits, in

terms of efficient and effective co-operative audit and control, are duly harvested.

Note :

Trainees should not be given suggestions for their action commitments, since the exercise of applying what they learn in the programme to their jobs is an essential part of the learning experience. The following examples of appropriate action commitments should only be used, with caution, if absolutely necessary; they are included more as a guidance for the instructor than as suggestions for trainees:

- "To assist co-operatives devise control systems appropriate to their type of activities, and to see to it that these systems are implemented in a manner that will effectively regulate the business, safeguard assets and ensure completeness and accuracy of records."
- "To train subordinates in the use of the four techniques of audit testing: Inspection, Observation, Enquiry and Computation and ensure that they apply them correctly when carrying out audits."
- "To ensure, when auditing a co-operative, that the existence, cost ownership, completeness, value and presentation of its assets are verified."
- "To prepare a comprehensive Audit Review checklist and use it when auditing co-operatives."

The "persuasion strategies" should be similarly brief, and may involve "lobbying" superiors, colleagues, and co-operative members and officials.

The specific "measurable achievement" must be able to pass the following tests: will the trainee him or herself, and an outside observer, be able to say definitely

whether or not it has been attained? It may only be an indicator of improvement, but should be quantified, or capable of a clear answer, "yes" or "no".

Participant's Action Commitment Form

Problem which the proposed change is designed to solve: _____

Action that is to be taken: _____

Persuasion Strategy by which the change will be introduced: _____

Specific Measurable Achievement:

By: _____ (a date not more than six months after the end of the training course) the following specific, measurable stage will have been reached in the implementation of this action commitment:

Signed: _____

Date: _____

Appendix I

AUDITING STANDARDS AND GUIDELINES

The major accounting bodies of the world are concerned that their members operate to minimum acceptable standards that are uniformly applied. In order to achieve this with regard to auditing, the various institutes and authorities have issued what are termed "auditing standards" or "guidelines".

As the standards vary in detail from country to country, it has not been considered appropriate to include published standards of any one country as part of the text of this manual.

In addition to individual bodies issuing auditing standards, the Council of the Federation of Accountants (IAFC) have released (to date) twenty-nine items of "International Auditing Guidelines". Their scope is described as follows: -

"These Guidelines apply whenever independent audit is carried out: that is, in the independent examination of financial information of any entity, whether profit oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon". (Preface to International Auditing Guidelines)

By necessity of operating in an international arena, the scope of each guideline is broad but it can be seen that these guidelines are applicable to co-operative organisations throughout the world.

The guidelines have been prepared by a group of international experts and are accepted as authoritative world-wide. As such they should be considered as important study material for auditors and are a useful back-up to this manual.

The full text of the International Guidelines has not been produced here as they are continuously being revised and ex-

panded. The Guidelines, or those specifically applying to your country, should be available at any school of accounting but if not, they can be obtained from any institute of accountants.

Given on the following page is a list of the issued Guidelines and the session number to which the Guideline can be applied. You may consider it advantageous to include part or all of some of the guidelines in certain sessions or as pre-session study material.

INTERNATIONAL AUDITING GUIDELINE NUMBER	TOPICS	PRINCIPAL SESSION NUMBER
1.	Objective and Scope of Audit of Financial Statements	1.3
2.	Audit Engagement Letters	5.3
3.	Basic Principles Governing an Audit	1.2
4.	Planning	5.1
5.	Using the work of Another Auditor	2.1
6.	Study and Evaluation of the Accounting Sys- tem and Related Inter- nal Controls in Con- nection with an Audit	4.2
7.	Control and Quality of Audit Work	5.1
8.	Audit Evidence	5.4
9.	Documentation	5.4
10.	Using the work of an Internal Auditor	2.1
11.	Fraud and Error	3.1
12.	Analytical Review	6.3
13.	The Auditors' Report	8.1
14.	Other Information in Documents containing Audited Financial Statements	5.4
15.	Auditing in an Elec- tronic Data Processing (EDP) Environment	10.1
16.	Computer-assisted Audit Techniques	10.1
17.	Related Parties	5.4

INTERNATIONAL AUDITING GUIDELINE NUMBER	TOPICS	PRINCIPAL SESSION NUMBER
18.	Using the work of an Expert	4.4
19.	Audit Sampling	6.2
20.	The Effects of an EDP Environment on the Stu- dy and Evaluation of the Accounting System and related Internal Controls	10.1
21.	Date of the Auditors' Report; Events After the Balance Sheet Date; Discovery of Facts Af- ter the Financial Sta- tements Have Been Is- sued	5.5
22.	Representations by Ma- nagement	7.5
23.	Going Concern	8.2
24.	Special Purpose Audi- tors' Reports	10.2
25.	Materiality and Audit Risk	3.1
26.	Audit of Accounting Estimates	10.2
27.	The Examination of Prospective Financial Information	10.2
28.	First Year Audit Enga- gement - Opening Balan- ces	5.1
29.	The Assessment of Inhe- rent and Control Risks and Their Impact on Substantive Procedures	4.4