

PROJEK PELAJAR/THESIS

THE NEED FOR AUDIT OF LEGAL FIRMS.

A Project Paper Submitted to School of
Accountancy, Mara Institute of Technology
in Partial Fulfilment of the Requirements
for the Advanced Diploma in Accountancy

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Date of Submission : 18th August 1990

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I dedicate this Project Paper to
my parents Hj.Taher Bin Hj.Mohtar and
Hjh. Fatmah Bt. Amin and to
Aishah Bt. Kaderi for their love
encouragement and moral support.

FOTOSTAT TIDAK DIBENARKAN.

Acknowledgement

I wish to express my deepest thanks and gratitude to all who assisted me in preparation of this project paper.

Of special mention to Mr. Lai Chee Leong and Mr. Nasharuddin Abd. Aziz of Shamsir Jasani & Co. (Kuala Lumpur) and Mrs Mahani Bt. Mohd Nasir of Shahir & Co. (Shah Alam) for their information supplied.

Equally, grateful I am to all the staffs of Shamsir Jasani & Co. and Aljeffri & Co. for their help and cooperation without which this project paper would not have been possible.

Finally, I wish to thanks my advisor Mrs. Noraiza Che Awang for her advice, assistance and guidance in the preparation and presentation of this paper.

Affendi Bin Taher.

Table Of Contents

	Page
Acknowledgement	(i)
Table of Contents	(ii)

CHAPTER

I	INTRODUCTION	1
	Terms of Reference	1
	Objectives	2
	Scope and limitations	3
	Methodology	4
	Introduction	5
	Justification	7
	Definitions	8
II	LITERATURE REVIEW	11
III	FINDINGS	
	Audit Requirements	16
	Types of Audit	18
	Introduction to Solicitors Account	19
	Problems Encountered	21
	Exemption from Delivery of an Accountant's Report	22

	Page
Audit Process	23
General	23
Cash in Hand	24
Bank Account	25
Creditors Account	31
Problems Encountered	34
Accountant's Report	36
Reporting of Accountant's Report	39

IV DISCUSSION and CONCLUSION

BIBLIOGRAPHY

APPENDIX

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CHAPTER I

INTRODUCTION

Terms of Reference

To fulfill a partial requirements of Advanced Diploma in Accountancy, a project paper for Subject ACC 556 on "The Need for Audit of Legal Firms" was carried out.

The project paper has to be submitted on 18th August 1990.

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Objectives

The main objective of this project paper is to study on the possibilities of auditing solicitors account, in view of some cases of lawyers abusing clients' money entrusted with them. It will include a study on the importance and need of auditing solicitors account.

This project paper also attempts to identify the problems and limitations faced by auditors while undergoing the audit of solicitors account.

It will also represent on the auditors duties before producing and satisfying an Accountant's Report to the Law Society.

Scope and Limitations

This project paper is confined to auditing process as requested by the Law Society, where its' audit performance is govern by the rules set by the Bar Council. It however will not look into the audit process as requested by the partners (solicitor) themselves for their own internal purposes.

The discussion will be based on the auditors point of view. This will not include views from the solicitors. The problems encountered by auditors are limited to errors which are commonly encountered by auditors in relation to audit of solicitors account.

The audit process described in this report are generally used by most of the audit firm in Malaysia. However, it will not represent an audit on Legal Firms who holds their account on a computer or other mechanical accounting system.

Methodology

In carrying out this project paper the following methods were used to obtain information.

1. Interviews were conducted with Shamir Jasani & Co., Aljeffri & Co. and Shahir & Co. personnel.
2. Studies were made using related reference literature such as prior year audit files, Accountant's Report Rules, Solicitor's Account Rules etc.....
3. Secondary data was obtained from books, journals and other related materials.

Introduction

"Auditing is a discipline which provides for an independent opinion to be issued about aspects of the financial performance of organisations, so that third parties (users of financial statements) who cannot themselves examine the performance under review may attach creditability to the financial statement issued by the entity's management".¹ The creditability and reliance to the financial statements lies in appointing an independent person called an auditor (external) to investigate the accounts and report on the findings.

The auditors opinion will be presented in a form of a report in which in his opinion adequate book-keeping and recording system are properly drawn up in accordance with the provisions of the Companies Act 1965.

There are few objectives of auditing, of which the primary object is to produce a report on his opinion of the truth and fairness of financial statements so that it can be relied upon. Other secondary objectives are to detect errors and fraud and as far as possible to prevent them from repeating. Beside it will also be able to assist the management with accounting, system, taxation, financial and other problems.

In the case of Legal Firms (Advocates and Solicitors) they are in partnership and they do not fall under mandatory requirements to be audited. However, under some circumstances or rules solicitors' accounts are audited.

It's audit is governed by the rulers set by the Law Society and in some instances audit is desired by the solicitors themselves. When auditing the solicitors account there are certain problems and limitations faced by auditors.

The scope of audit on legal firms are not the same as audit of companies account. Only certain accounts are audited, meaning that it does not constitute a full audit and their purpose of auditing the account is to see that solicitors keep proper and adequate records of the clients transactions.

As far as cash and bank balances and creditors accounts are concerned, auditing process of solicitors account are almost similar to that of companies. The basic idea behind audit undertaken is that solicitors shouldn't misappropriate (misused) the clients' money and solicitors are professionals who are supposed to be honest in performing his or her duties.

On completion of audit work, an accountant is in a position to sign his or her report (Accountant's Report) to the Law Society (Bar Council). Before signing the Accountant's Report, the accountant must make sure that everything is proper and in compliance with the rules set by the Bar Council.

For each practising year, solicitors are required by the Bar Council to apply a practising certificate for the following year, if they are to continue practising. Together with this application solicitors will have to submit the "Accountant's Report". However, there are instances where they are exempted from rendering the report. (Legal Profession Act, 1976. P.106)

Justification

Solicitors are suppose to keep clients' money at all times separate from their own and that adequate records are maintained of clients' transactions. However, there are cases where solicitors are dishonest to their client, where they misappropriate the clients' money entrusted with them.

For example, in 1981 a Singapore case concerning advocates and solicitors, where a solicitors' legal assistant named Santhiran, due to his improper conduct in the discharge of his professional duty within the

meaning of section 84 (2)(b) of the Legal Profession Act, had misappropriated sums totaling \$298,270.75 from the clients' account. It was held that the solicitor is ordered to be suspended from practise for a period of two years and to recover the amount owed. For details see Appendix (i).

Eventhough cases of misappropriation are seldom heard, it must be remembered that practising solicitors are at all times exposed to those situations. Thus, there's a need for legal protection on the clients' money kept by solicitors.

If we see and try to ask people about solicitors liability to its client and the need of audit for Legal Firm, only few I think will realise about it. General public usually are not aware of the fact that solicitors need to render their "Accountant's Report" annually and for what other reasons audit on Legal Firms are necessary.

Definitions

Auditing

Auditing can be defined as "an independent examination and expression of opinion on the financial statement of an enterprise by an appointed auditor in pursuant of that appointment and in compliance with any statutory

obligation"².

It can also be defined as "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users"³.

Partnership

"Partnerships may be defined as the relation which subsists between persons carrying on a business in common with a view of profit"⁴. It consist of at least two partners but not more than twenty. However, for a professional partnerships such as solicitors, doctors and accountants, it can be more than twenty but must not exceed fifty.

Solicitors

'Solicitors' or 'advocate and solicitors' means advocate and solicitors of high court admitted and enrolled as a member of the Bar Council.

Law Society

Law Society can mean Bar Council or Malaysian Bar who is a body corporate and with power subject to Legal Profession Act 1976.

Accountant

Accountant is an approved company auditor as defined in the Companies Act 1965 and he has neither been at any time during the accounting period, nor subsequently, before giving his report, became a partner, clerk or servant of such solicitor or of any partner of his and as well not subject to notice of disqualification by the Bar Council.

CHAPTER II

LITERATURE REVIEW

Literature Review

"An audit involve satisfying oneself that accounts have been prepared in accordance with generally accepted accounting principles, and audit are themselves done under approved auditing standard". It is true that every audit should follow the guidelines available. For audit of solicitors account, it can be considered as 'special' because of its unique features. What is meant here is, of course, specialized undertakings calling for special knowledge for auditors or for which there are special accounting or auditing requirements.

Under the Companies Act 1965 Section 167 states that.... Every company and the director and managers thereof shall cause to be kept such accounting and other records as will sufficiently explain the transactions and financial position of the company and any document required to be attached thereto to be prepared from time to time, and shall cause these records to be kept in such manner as to enable them to be conveniently and properly audited. It clearly states that a company must keep adequate accounting records and it should be audited. This only applies to companies and not solicitors firm.

Section 79 of Legal Profession Act, 1976 talks about "Accountant's Report" and not stating specifically the

need of audit for legal firm. From the word "Accountant's Report" it can be deduce that to produce an "Accountant's Report" the accountant will have to audit the solicitors account.

In Solicitors Account Rules 1978 and Accountant's Report Rules 1978, states that in order to ascertain whether the rules have been complied with, the accountant will have to audit the solicitors account. However, only general examination are allowed on the books of accounts of the solicitors. So, this is the only rule that governs the audit for legal firm and these rules are set by the Bar Council.

The purpose of solicitor is to provide advice, assistance and representation to his clients. He must give them the service which they require, and he must do this honestly and within the constraints of the professional code. Moreover, his services must be provided at both an affordable cost to the clients and some profit to himself, otherwise he will be unable to carry on. A good solicitor must have the following qualities:

1. Honesty and Integrity
2. Knowledge of the substantive law and specific legal procedures.
3. A nose for what is important

4. Skill in conducting a case in all its different aspects on day to day basis.

In other words, solicitors should have the skill and ability to perform his duty professionally.

All solicitors' offices conduct two separate bank accounts, each with its own set of accounting records or books. The purpose of clients account is to record all money paid or held on behalf of client or money paid in by a third party for the purpose of a client. An office account is used for the general conduct of the office, including amounts of payments on behalf of particular clients (client's disbursement). Into it are paid all costs collected and money in reimbursement of clients' disbursements.

The clients' ledger are the centre or focal points of the systems. They tell how much solicitors are holding on behalf of an individual client in respect of a particular matter. The clients' money in this account are their deposit as required by solicitors for handling their case and it relates to an estimate given by solicitors. It should be sufficient enough to cover both the initial profit cost and disbursements. In some extend interim billing are necessary where the deposits are insufficient. The bill rendered should be for work actually done, not a request for money on account in

respect of work still to be done.

The client's money deposited in the bank by solicitors earn interest and, all interest earned on deposit kept are theirs. Under the case of *Toh Theam Hock v. Kemajuan Perwira Management Corporation Sdn. Bhd.*, it was held that solicitors are entitled to keep for himself any interest that accrues to the deposits of clients money kept by solicitors at the bank. Details of the case is in Appendix (ii).

In the case where the accounts are held on a computer or other mechanical accounting system, the law society however recognises that checks on clients account would merely amount to a check on the performance of the machine. The accountant may rely on a waiver of the strict rule and carry out a test check of the extraction where:

1. the solicitor uses a computerised or mechanical system of accounting which automatically produces an extraction of all clients ledger balances;
2. there is a satisfactory system of internal control in operation;
3. the auditor states in his report that he has relied on the waiver.

Briefly under the Solicitors Accounts Rules 1978 it mainly deals with the maintenance of clients' account and keeping track of all transactions with clients and to record them in an appropriate and proper manner. The Accountant's Report Rules 1978 talks about the production of Accountant's Report and their duties before signing the report. This rules as well states about their qualification to be an accountant (auditor).

Broadly the purpose of all the rules are:

1. "to require a solicitor to keep clients' money separate from his own money;
2. to ensure that a solicitor keeps adequate records of his transactions so that his book shows money received and paid and balance held on account of each client;
3. to ensure that money of each client is clearly distinguished from that of other clients, and from other money passing through solicitors accounts".⁶

The writer have looked into Accountants Journal, Malayan Law Journal and Solicitors Journal, but until this report is produced the writer could not find any articles or written materials which provides the present trend of audit process and limitation by auditors in the field of audit concerning Legal Firms.

CHAPTER III

FINDINGS

Audit Requirements.

There are no requirements in the Act that governs directly on audit of solicitors account. In the Companies Act 1965 it only stressed on the audit of companies and not solicitors account or legal firm generally. Thus, it is not a mandatory requirement to audit the solicitors account.

On the other hand, there are rules set by the Bar Council on audit of the solicitors' accounts. Although, it only talks about "Accountant's Report" and not stating specifically the need of audit on Legal Firm. It is understood that to produce an "Accountant's Report" the solicitors account should be audited by an independent person. Meaning that, auditors need to examine the books and account of an advocate and solicitors firm and of any other relevant documents with a view to the preparation of the "Accountant's Report". This is to ascertain whether solicitors have complied with the rules set by the Bar Council.

From the auditors perspective, they are appointed by the solicitors to be their auditor and to produce an independent report annually. Basically there are two parties who request an audit of solicitors account. First, is by the Bar Council of which they act either on its own motion or on a written complaint lodged with it