COLLAGE OF MANAGEMENT AND PUBLIC SERVICE

DEPARTMENT OF ACCOUNTING AND FINANCE

AUDITING PRINCIPLES AND PRACTICES-I

(ACFN4061)

January 2023

Table of Contents

Contents

Table of Contents 3

Preface 4

About the Course 5

Chapter 1: An Overview of Auditing 8

Chapter 2: The Auditing Profession 23

Chapter 3: Planning and Conducting the Audit 42

Chapter 4: Internal Control 56

Chapter 5: Audit Evidence 71

Chapter 6: Audit Reports 83

Chapter 7: Auditing and Auditors in Ethiopia 94

Answer Key 104

References 108

Chapter 1: An Overview of Auditing

Dear Learners!

Independent audit function plays an important role in business, economy and society. Different decisions are typically based upon the information available to the decision maker. To obtain the most benefit, users should have economic information that is both relevant and reliable. This need for relevant and reliable financial information creates a demand for accounting and auditing service. Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent and independent person. Auditing enable the auditor to express opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. This framework (criterion) might be generally accepted accounting principles (GAAP), or the national standard of a particular country. In this chapter, you will learn about meaning of auditing, historical development of auditing, types of audit and auditors and economics of auditing.

Objectives of the Chapter: after completing study on this chapter, student be able to;

After studying this chapter, you should be able to:

1. Define auditing.
2. Describe Historical Development of Auditing.
3. Identify Types of Audits and Auditors.
4. Explain Economics of auditing

1.1. Nature and Definition of Auditing

Different scholars have defined auditing in different ways. For example, Auditing is a process of collection and evaluation of evidence for the purpose of reporting on economic transaction. The other definition of auditing given by the Institute of Chartered Accountants of India, in its publication titled, General Guidelines on Internal Auditing has defined auditing as _‘ a systematic and independent evaluation of data, statements, records, operations and performances (financial or otherwise) of an enterprise for stated purpose. In any auditing situation, the auditor perceives

and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his/her judgment which is communicated through audit report.

As it is cited in Kanal Gupta and Arora A.(1996,p6), Arens and Loebbecke defined auditing as the process by which a complete, independent person accumulates and evaluates evidence about quantifiable information related to specific economic entity for the purpose of determining and reporting on the degree of correspondence between the quantifiable information and established criteria. To sum up, Auditing is the process of verifying the assertions produced by accounting, as to whether they present a true and fair view of the entity's financial position in accordance with accounting standards and GAAP. In other words, auditing seeks to verify whether or not financial records have been properly prepared.

Study Note

- *The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them Auditing is as old as accounting.*
- *It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. The Vedas contain reference to accounts and auditing.*
- *The original objective of auditing was to detect and prevent errors and frauds and most recently objective of audit shifted to ascertain whether the accounts were true and fair rather than detection of errors and frauds.*
- *Auditing evolved and grew rapidly after the industrial revolution in the 18th century with the growth of the joint stock companies the ownership and management became separate.*
- *The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.*

Activity

Question 1.1: *Describe the meaning of auditing and discuss its evolution?*

_____

_____

_____

1.2. Historical Development of Auditing

The development of auditing is closely linked to the development of accounting. In the early stage of civilization, the number of transaction was usually so small that able to record the transactions himself. However, with the growth of civilization and consequential growth in volume and complexity of transactions, it becomes necessary to entrust the job of recording the transactions to other persons. The trend started with maintenance of accounts to empires by public officials. Almost simultaneously, a need was felt of institute to check on the fidelity of persons responsible for maintaining the accounts. To accomplish this purpose, it became customary to hear those who had maintained the accounts. In the course of time, such persons came to be known as auditors, the term being derived from the Latin word _'audiure'' which means to hear.

The major development of auditing may be summarized as follows:

1. Auditing was conducted through a public hearing and its objective was verification of cash receipts. It was simply a cash audit.
2. Auditing started to be conducted through examination of all the transactions of an organization instead of hearing what the bookkeepers say the objective of auditing was to detect errors and frauds.
3. The objective has become, starting from the first half of the 20th century, determination of whether the financial statements present the true and fair view of the organization.
4. Sampling technique has been introduced instead of examining each and every transaction.
5. Computer is being used for effective carry out the auditing process.

Study Note

- ✓ *Starting from the first half of 20 century, the objective of auditing shifted to determine whether financial statements present the true and fair view of an organization. Sampling technique and the use of computer have been used in the auditing process in recent*

times.
Activity **Question 1.2:** *Describe historical development of auditing.* _____ _____ _____

1.3. Accounting vs. Auditing

The company structure is built upon the principles of stewardship. Shareholders invest capital into the company and hire professional managers to manage the company. The disadvantage is that these same managers might perform fraud and errors. In public listed companies, it is very hard for shareholders to actually check on the performance of management. That is why accounting standards were developed. The standards prescribe the proper procedures for financial reporting. But how do shareholders know whether or not managers have been following these accounting standards? The answer is simple - the auditor's report will tell them the answer. In other words, accounting standards are the law, and auditors are the law enforcers.

Many financial statement users and members of the general public confuse auditing with accounting. The confusion results because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by the fact that auditing is performed by individuals described as public accountants. Accounting is the process of recording, classifying and summarizing economic events in a logical manner for the purpose of providing financial information for decision-making. Accounting involves tracking, reporting, and analyzing financial transactions. It covers everything from preparing individual tax returns to preparing financial statements for multinational corporations, and is considered a fundamental discipline within the field of accounting. An audit is an independent examination of accounting and financial records and financial statements to determine if they conform to the law and to Generally Accepted Accounting Principles (GAAP). Accounting is constructive, it starts with the raw financial data to process and produce financial summary through reports known as financial statements as the

end product of its work. The function of accounting, to an entity and to society as a whole, is to provide certain quantitative information that management and others can use to make decisions. To provide relevant information, accountants need to have a thorough understanding of the rules and principles and provide the basis for preparing the accounting information.

Auditing on the other hand is analytical work that starts with the end product of accounting to lend credibility and fairness of the measurements. In auditing, the concern is with determining whether recorded information properly reflects the economic events that occurred during the accounting period. Since the accounting rules and principles are the criteria for evaluating whether the accounting information is properly recorded, any auditor involved with this data must also thoroughly understand the accounting rules and principles. In the context of the audit of financial statements these are generally accepted accounting principles (GAAP).

In addition to understanding accounting, the auditor must also possess expertise knowledge in the accumulation and interpretation of audit evidence, determining the proper audit procedures, sample size, particular items to examine, timing of the tests, and evaluating the results are unique to the auditor. It is this expertise that distinguishes auditors from accountants.

Significance of Auditing to the society: There are a number of advantages of auditing to the modern society. These are;

A tool of control over those who handle resources belonging to others

The first and foremost advantage of auditing is that it acts as a tool of control over those who handle the resources belonging to others. For example, in the case of government departments, audit seeks to ensure that the officials use the public funds properly. Whenever a person or authority is entrusted with the resources belonging to others, it becomes necessary to exercise suitable control over such person or authority to ensure that the resources are used properly. The mere fact that there would be an audit of accounts acts as a check on those using the funds and makes them cautious. Similarly, it acts as a moral check on employees, since they fear that any errors or frauds would be discovered by the auditor. Thus it acts as a means of protection against misuse of funds and reduces the possibility of errors and frauds.

A tool for enhancing credibility of economic information

This is another important advantage of auditing that it enhances the credibility of economic information. It is obvious that one would place greater reliance on statement if it had been

audited than would be the case otherwise. This is because the auditor is an independent and objective expert who has no stake in the management of the organization under audit. Thus, the shareholders of a company would place greater reliance on the balance sheet and the profit and loss account of the company, if the auditor expresses the opinion that this statement presents a true and fair view. Apart from the shareholders, other users of financial statements of an enterprise (like tax authority, banks, creditors, investors, labor-representatives,) also place greater reliance on them if they have been audited.

A tool for improving economy and efficiency in the use of resources

Certain types of audit conducted specifically to review the operations and activities so that wastages and losses can be minimized, weaknesses in the system can be identified and overcome, and controls can be strengthened. In such audits (generally known as internal audit or operational audit or management audit), the auditor makes recommendations for improving the economy and efficiency with which resources are employed.

A tool for certain special audit

Some types of audit are conducted for certain special purposes such as for checking income for tax purpose, emergent audit of a company cash in box, periodic checking of a company inventories, etc. In summary, the contribution (need) of auditing from the view point of owners, management, third parties like investors, creditors and employees, and the government are discussed below.

To owners:

- Greater reliability of financial statements
- Improvement in efficiency with consequential audit increase in profitability
- Over all check on integrity of management

To management:

- Improvement in management control and check integrity of employees
- Relatively easier to deal with third parties like banks, financial institution, creditors, and insurance companies due to credibility of audited financial statements
- Greater reliability of tax returns
- Greater confidence of owners in management‘s integrity
- Assurance about compliance with specified legal requirements

- More efficient use of resources through identification of inefficiencies leading to the remedial action

To potential investors, creditors, employees, and others:

- Greater reliability of financial statements as providing a data base for taking investments, credit, and other decisions.

To government:

- ✓ Greater reliability of financial and cost information as basis for policy decisions like reduction/ increase in subsidies, tax rates, and for price fixation
- ✓ Greater reliability of tax returns submitted by taxpayers

Study Note

The contribution of auditing from the view point of owners, management, third parties like investors, creditors and employees, and the government are;

- *Greater reliability of financial statements and over all check on integrity of management*
- *Improvement in efficiency with consequential audit increase in profitability*
- *Improvement in management control and check integrity of employees*
- *Relatively easier to deal with third parties like banks, financial institution, creditors, and insurance companies due to credibility of audited financial statements*
- *Greater reliability of tax returns, Greater confidence of owners in management's integrity and assurance about compliance with specified legal requirements*
- *More efficient use of resources through identification of inefficiencies leading to the remedial action.*
- *Greater reliability of financial statements as providing a data base for taking investments, credit, and other decisions.*
- *Greater reliability of financial and cost information as basis for policy decisions like reduction/ increase in subsidies, tax rates, and for price fixation*

Activity

Question 1.3: *Discuss the advantage of Auditing for the economy.*

_____

_____

_____

1.4. Types of Audits and Auditors

There are three types of audits. These are discussed below.

1. Financial Statement Audit: is conducted to determine whether or not financial statements are presented in accordance with GAAP. The most common financial statements that should be audited by the auditors are Balance sheet, Profit and loss statement, and cash flow statement including the accompanying foot notes. Financial statement audits are normally performed by firms of certified public accountants and users of auditor‘s report include management, investors, bankers, creditors, financial analysts, and government agencies.

2. Operational Audit: is a review of any part of an organization‘s operation procedures and method for the purpose of evaluating effectiveness and efficiency. This type of audit examines:

- The economy of administrative activities in accordance with sound administrative principles and practices, as well as management policies;
- The efficiency of utilization of human, financial, and other resources including examination of information systems, performance measures and monitoring arrangements, and procedures followed by audited entities for remedying identified deficiencies; and
- The effectiveness of performance in relation to achievement of the objectives of the audited entity and audit of the actual impact of activities compared with the intended impact.

Here, some of the areas that should be audited are evaluation of organizational structure, computer operations, production methods, marketing, and any other areas in which the auditor is qualified.

3. Compliance Audit: the purpose of compliance audit is to determine whether the client is following rules, procedures, regulations, and policies set down by the management. Such type of audit includes the process prescribed by a company controller, reviewing wage, bonus, and dividend rates, and examining contractual agreements. Like that of audits there are also three types of auditors.

1. **Independent (External) auditors:** these are the auditors‘ of private audit firm. The audit firm will sign audit contract in order to examine evidence and provide audit report to the concerned party. Thus, the independent auditors received a fee from the audited organization and they are primarily responsible to third parties (shareholders).

2. **Internal auditors:** are permanent employees of the client and get a monthly salary. They are primarily responsible to the management or the board of directors. Internal auditors lack independent in appearance (are not free from financial and family relationship) from the client since they are the employees of the audited organization, but they should satisfy independence in (Objective). To be objective:

- They should not be a member of any committee in the organization
- They should provide their report not to the department heads rather to the manager.

3. **Government auditors:** are the employees of the government not the audited organization. They are the auditors‘ of Federal government and/or Regional government and primarily responsible the legislative or executive body. Such type auditors will assign to audit selective government organization.

Study Note

- *The different types of audits are Financial Statement Audit, Operational Audit and Compliance Audit*
- *The different types of audits are Independent (External) auditors, internal auditors and Government auditors.*

Activity

Question 1.4: *Discuss about the different types of audits and auditors*

_____

_____

_____

_____

1.5. Economics of Auditing

Quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits. The audit firm should implement quality control policies and procedures designed to ensure that audits are conducted in accordance with SASs, where applicable. The nature, timing and extent of an audit firm's quality control policies and procedures depend on a number of factors such as the **size** and **nature** of its practice, its **geographic dispersion**, its organization and appropriate **cost or benefit consideration**s.

Accordingly, the policies and procedures adopted by individual audit firms vary, as does the extent of their documentation.

The objectives of the quality control policies to be adopted by an audit firm ordinarily incorporate matters set out below.

A. **Requirements of professional ethics statements**: personnel in the firm are to adhere to the Statements of Professional Ethics especially relating to the principles of Independence, integrity, objectivity, confidentiality and professional behavior.
B. **Skills and competence:** the firm is to be staffed by personnel who have attained and maintain the technical standards and professional competence required to enable them to fulfill their responsibilities with due care.
C. **Acceptance and retention of clients**: prospective and existing clients are evaluated and reviewed on an ongoing basis. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly, and the integrity of the client's management are considered.
D. **Assignment**: audit work is assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
E. **Delegation**: sufficient direction, supervision and review of work at all levels are carried out in order to provide reasonable assurance that the work performed meets appropriate standards of quality.
F. **Consultation**: whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.
G. **Monitoring**: the continued adequacy and operational effectiveness of quality control policies and procedures are monitored.

The audit firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.

Auditors should implement those quality control procedures which are, in the context of the policies and procedures of the audit firm, appropriate to the individual audit. Auditors, and assistants with supervisory responsibilities, consider the professional competence of assistants to

whom work is delegated when deciding the appropriate extent of direction, supervision and review. Any work delegated to assistants is directed, supervised and reviewed in a manner which provides reasonable assurance that such work is performed competently and with due care. Assistants to whom work is delegated need appropriate direction. Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved. There are various means of directing assistants. For example, an audit program and oral briefings during the course of the audit are important tools for the communication of audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

Supervision is closely related to both direction and reviews and may involve elements of both. Personnel carrying out supervisory responsibilities perform the following functions during the audit:

A. monitor the progress of the audit to consider whether:

- Assistants have the necessary skills and competence to carry out their assigned tasks; and
- They should understand the audit directions; and iii. the work is being carried out in accordance with the overall audit plan and the audit program;

B. become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and the audit program as appropriate; and

C. Resolve any differences of professional judgment between personnel and consider the level of consultation that is appropriate.

The work performed by each assistant is reviewed by personnel with greater competence and experience to ensure that:

- The work has been performed in accordance with the audit program;
- The work performed and the results obtained have been adequately documented;
- All significant audit matters have been resolved or are reflected in audit conclusions;
- The objectives of the audit procedures have been achieved; and

- The conclusions expressed are consistent with the results of the work performed and support the audit opinion.

The following are reviewed on a timely basis:

- the overall audit plan and the audit program;
- assessments of inherent and control risks, including the results of tests of control and the modifications, if any, made to the overall audit plan and the audit program as a result thereof;
- documentation of the audit evidence obtained from substantive procedures and the conclusions drawn there from, including the results of consultations; and
- Financial statements, proposed audit adjustments and the proposed auditors' report.

The process of reviewing an audit may include, particularly in the case of large complex audits, requesting personnel not otherwise involved in the detailed audit to perform certain review procedures before the issue of the auditors' report, e.g., to consider specific areas of audit judgment and to review the draft annual report prior to its publication and distribution. Finally, compliance with the auditing standards contained in this SAS ensures compliance in all material respects with the basic principles and essential procedures in International Standard on Auditing.

Activity

Question 1.5: *Discuss about Economics of auditing and quality control procedures.*

_____

_____

_____

Chapter Summary

The original meaning of the term Audit is derived from the Latin word _Audere‘ which means _to hear‘ and the term Auditor is _one who hear‘. In earlier periods, commercial and governmental records were approved only after a public reading in which the accounts were read allowed to peoples those hear. From medieval period up to the industrial revolution Audit were performed to determine whether person in position of official responsibility in government and commerce were acting and reporting in an honest manner. During the industrial revolution, manufacturing companies grew in size and their owners began to use the service of hired managers. With this

separation of the ownership and management groups, the owners turned increasingly to the need of auditors to protect themselves from the danger of intentional error as well as fraud committed by managers and employees. Before 1900, consistent with this primary objective of detecting error and fraud, auditors often include a study of all, or almost all recorded transactions. In the first half the 20th century, the direction of audit works tends to move away from fraud detection towards a new goal of determining whether financial statements give a full and fair picture of financial position, operating results, and change in financial position. Although banks were the primary users of financial reports, auditors become more responsible to stockholders, government agencies and to other parties who might rely up on financial information. In the middle of 20th century, the large scale corporate entities growth rapidly, and auditory began to examine selected transaction rather than study all transactions. auditors and business managers gradually comes to accept the careful examination of relatively few transactions selected at random and they believe that it would be a cost effective and reliable indication of the accuracy of other similar transaction. In addition to sampling, auditors become aware of the importance of effective internal control. A company internal control consists of the policies and procedures established to provide reasonable assurance that the objective of the company will be achieved. Auditor found that by studying the firm‘s internal control they could identify areas of strength and weaknesses. Now a days, Auditors began to use sophisticated computer software to test the intensity of firm‘s internal control and the accuracy financial statement balances. Auditing is the systematic examination of records and documents to determine adequacy and effectiveness of budgeting, accounting, financial, and related policies and procedures; compliance with applicable statutes, regulations, policies, and prescribed procedures; reliability, accuracy, and completeness of financial and administrative records and reports; and the extent to which funds and other resources are properly protected and effectively used.

Glossary of Terms

Auditing is a systematic and scientific examination of the books of accounts of a business. Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

Auditor is a person or a firm appointed by a company to execute an audit.

Accounting is the process of recording, classifying and summarizing economic events in a logical manner for the purpose of providing financial information for decision-making.

Audits of financial statements: - The goal is to determine whether the financial statements have been prepared in conformity with generally accepted accounting principles.

Operational audits: - An operational audit is study of some specific unit of an organization for the purpose of measuring its performance.

Compliance audits: - Compliance audit determines whether the specified rules, regulations, or procedures are being carried out

Chapter Review Questions 1

Part I: Write ''TRUE'' if the statement is correct and ''FALSE'' otherwise.

1. The work of auditing begins after the work of accounting ends.
2. Internal auditors do not satisfy independent in appearance
3. One of the differences between accounting and auditing is that financial statements are the input for the former and the output for the latter one.
4. In the early periods, auditing was conducted through a public hearing and its objective was verification of true and fair view of an organization.
5. The development of auditing was not closely related to the development of accounting.

Part II: Choose the correct answer for the following multiple choice questions.

1. Review of any part of an organization‘s operation procedures and method for the purpose of evaluating effectiveness and efficiency is;
   A. Compliance audit
   B. Operational audit
   C. Internal Audit
   D. Financial statement audit
   E. None of the above
2. Independent auditing can best be described as;
   A. A branch of accounting.
   B. A discipline that attests to the results of accounting and other functional operations and data.
   C. A professional activity that measures and communicates financial and business data.
   D. A regulatory function that prevents the issuance of improper financial information.

E. None of the above

3. Examining documents starting with the recorded transactions back to source documents is;
   A. Mechanical accuracy
   B. Tracing
   C. Vouching
   D. Scanning
   E. None of the above
4. A type of audit which may conduct to check whether each employee carryout his/her duties and responsibilities based on the established policies, procedures, rules, and regulations is called:
   A. Financial statement audit
   B. Operational audit
   C. Compliance audit
   D. Management audit
   E. All of the above
5. Individual auditors, whether government or public should be free from personal and external impairment, this statement implies;
   A. Dueprofessionalcare
   B. Competence
   C. Independence
   D. Proficiency
   E. None of the above

Chapter 2: The Auditing Profession

Dear Learners!

Profession is a specialized body of knowledge that provides intellectual services to the best interest of the public and which has gained public confidence and trust. Ethics consists of moral principles and standards of conduct imposed by a profession on its members. Professional ethics provides guidance to practitioners for maintaining professional attitude and it encourages high level of performance.

The need for professional ethics arises out of characteristics of profession such as:

- Responsibility to serve the public
- Complex body of knowledge
- Standard of admission to profession
- The need for public confidence

Professional Ethics in Public Accounting: ***Quotation by Marcus Aurelius***‖ *a man should be upright; not be kept upright"*. The thrust of this quote suggests that ideal conduct should be expected not mandated by formal rules and regulations. But in reality, people are motivated by a variety of conflicting pressures, for this reason, most professional organizations promulgate a formal code of conduct. The purpose of this chapter is to explore the role of self-regulation and address some of the ethical issues faced by accountants and auditors, and to enable students to obtain a critical understanding of the practice and function of auditing in ensuring the accountability of organizations to interested parties.

Objectives of the Chapter: After studying this chapter, you should be able to;

1. Discuss about generally accepted auditing standards
2. Identify Professional ethics.
3. Describe the legal responsibility and liability

2.1. Generally Accepted Auditing Standards

Standards are means of measuring the quality and performance of auditors. In order to provide and maintain uniformly high quality audit work there is a need to have generally accepted auditing standards. There are ten GAAS recognized by AICPA which are divided in to three categories.

1. **General standard(skill, objective,& due care)**

These standards speak to the capability in the field of accounting and auditing as well as technical knowledge of specific industry or organization under audit, character, and conscientiousness of auditors. The auditors‘ capability can be acquired through education and experience. The auditors‘ character relates with their objectivity in performing the audit work. In addition to auditors‘ capability and character, auditors should be wise or careful in the audit activities.

Under this standard, there are three GAAS as shown below.

a. The audit is to be performed by person or persons having adequate technical training and proficiency as an auditor (***competence***).
b. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors ***(independence***).
c. Due professional care is to be exercised in the performance of the audit and the preparation of the report (***careful, conscious, or wise***).

2. **Field work standards(well planning ,understanding the ICS &gathering sufficient data)**

The standards of field work are necessary of an audit plan which would be developed after the auditor has sufficient understanding of the client. This standard also requires an auditor to gather sufficient evidence using various auditing techniques to issue an opinion concerning the financial statements. Thus, there are also three standards of GAAS under field work standards (planning, understanding the client‘s internal control system, and competence of the audit work).

a. The audit work should be adequately planned. The reasons for planning the audit work are:

- To complete the audit work based on the stated time
- It helps to the auditor not to skip some works if he/she became busy
- To assign assistances, if any

b. A sufficient understanding of ICS of the client is to be obtained in order to plan the audit and determine the nature, timing, and extent of testing to be performed.
c. Sufficient and competence evidential data is to be obtained through inspection, observation, inquiry, examination, and/or conformation to afford reasonable bases for an opinion regarding the financial statements under audit.

3. **Reporting standards(GAAP, consistency, disclosure, and fair opinion)**

a. The audit report shall state whether or not financial statements are prepared in accordance with GAAP.

b. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
d. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed the reasons therefore should be stated. In all cases when an auditor‘s name associated with financial statements, the report should contain a clear-cut identification of the charter of the auditor‘s work, if any, and the degree of responsibility he/she is taking. In other words, the auditor should provide fair opinion to the concerned party.

The standards of reporting requires that the auditor should, in his/her report state whether the financial statements are prepared according to GAAP, and state if these principles have been applied consistently. The auditor should also describe the presence of necessary information in the financial statements that may have material effect on the reported data. After completing the audit, the auditor should issue an audit opinion on the financial statements, and justify whatever the opinion.

Study Note

There are ten GAAS recognized by AICPA which are divided in to three categories.

- *General standard(skill, objective,& due care)*
- *Field work standards(well planning ,understanding the ICS &gathering sufficient data)*
- *Reporting standards(GAAP, consistency, disclosure, and fair opinion)*

Activity

Question 2.1: *Discuss about generally Accepted auditing standards.*

_____

_____

_____

2.2. Professional Ethics

The American Institute of Certified Accountant‘s code of ethics consists of two parts: the principles and the rules. The principles are basic frames of references for the rules. The rules

govern the performances of professional services by members and are enforceable applications of the principles.

A. Principles: There are six Principles of Professional Ethics

I. Responsibilities: In carrying out their services as professional, members should exercise sensitive professional and moral judgments in all their activities. Auditors play significant role in the society by rendering different types of services that are essential to make various decisions, which involves usage of scarce resources. Therefore, all members have responsibilities to those who use their professional services. Besides, auditor has responsibility to corporate which each other to:

- Improve their profession
- Maintain the public confidence ,and
- Carryout the profession‘s self-governance responsibilities

Application of this principle increases the quality of professional services rendered by auditors and thereby boosts the status of the profession.

II. The public interest: Members should accept the obligation to act in a way that will serve the public trust and demonstrate commitment to professionalism. The public interest of an auditor is the collective wellbeing of the community of people and institutions that use its services. These include clients, creditors, governments, employers, investors, and the public at large, who rely on the objectivity and integrity of auditors. This reliance imposes high reliance of responsibility on the auditors. In discharging their responsibilities, members of the profession may encounter conflicting pressures between information providers and users. This conflict would be resolved when auditors carryout their responsibilities with integrity.

Auditors should show their commitment to honor the public trusts to those who rely on their services: i.e. they expected to provide quality services within integrity, objectivity, and due professional care.

III. Integrity: To maintain and broaden public confidence members should perform all professional services with the highest form of integrity.

In order to maintain the public trust and confidence members should act in an honest manner. Integrity is measured by what is right and just in the circumstances. Integrity means in this case, acting according to the code of professional conduct (ethical standards).

IV. Objectivity and independence: A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibility. A member in public practice should be

independent in fact and appearance when providing auditing and other attestation services. This principle requires auditors to avoid circumstances that involve conflicts of interest. Independence in fact refers that the auditor should maintain an objective and impartial mental attitude throughout the engagement. Independence in appearance refers to the relationship between the CPA and the client must appear to be independent to third parties. The auditors‘ opinion will get credibility if the users perceive that the auditor as objective and impartial.

V. **Due Care:** A member should observe the profession technical and ethical standards, strive continually to improve competence and quality of service; and discharge professional responsibility to the best of the member‘s ability. Due professional care applies to the exercise of professional judgment in the conduct of the work performed. Due professional care implies that the professional approaches matter requiring professional judgment with proper diligence.

VI. **Scope and nature of service:** A member in public practice should observe the principles of the code of professional conduct in determining the scope and nature of services to be provided.

The auditor should consider the above principles in deciding to provide the specific services in specific situations. In addition, members should:

- Practice only in firms that have adequate internal control procedures
- Determine whether the scope and nature of other services requested by an audit client would create a conflict of interest in providing auditing.
- Assess whether the requested service is consistent with his role as a professional

B. Rules: Rule is an accepted principle or instruction that states the way things are or should be done, and tells you what you are allowed or are not allowed to do:

Rule 101 Independence

A member in public practice shall be independent in the performance of professional services as required by council. A member should be independent in financial statement audit, review, and examination of prospective financial statements for his/her is attesting information to third party. But he/she does not have to be independent in rendering accounting, tax, or management advisory services.

The AICPA has also adopted the following interpretation of the rule. Independence shall be considered to be impaired if, for example, a member has any of the following transactions, interests, or relationships.

A. During the period of professional engagement or at the time of expressing an opinion, a member or a member‘s firm:
   1. Has/or was committed to acquire any direct or indirect financial interest in the enterprise.
   2. Was a trustee of any trust or executor or administrator of any estate if such trust or state has or was committed to acquire any direct or material indirect financial interest in the enterprises?
   3. Had any joint, closely held business investment with the enterprises or with any officer, director, or principal stockholders thereof that of material in relation to the member‘s net worth or to the net worth of the member‘s firm.
   4. Had any loan to or from the enterprise or any officer, director, or principal stockholder of the enterprise. This prescription does not apply to the following loans from a financial institution when made under normal lending procedures, and requirements:-Loans obtained by a member or a member‘s firm that are not material in relation to the net worth of such borrower Home mortgages and Other secured loans
B. During the period covered by the financial statements, during the period of the professional engagement, or at the time of expressing an opinion, member or a member‘s firm:
   1. Was connected with the enterprise as a promoter, underwriter or voting trustee, as a director or officer, or in any capacity equivalent to that of member of management or of any employee.
   2. Was a trustee of any pension or profit sharing trustee of the enterprise?

The above examples are not intended to be all-inclusive. To have a clear understanding of the rules, in what follows we will see the application of independence rule in relation to professional services, individuals, and time period.

Professional services; independence rules applies to auditing and other attestation services such as review of financial statements, examination of financial forecasts. The independence rule applies to:

- All parents or shareholders of the audit firm
- All managerial employees assigned to an office that significantly participates in the engagement
- All professional staff personally participating in the engagement

Therefore, it is not required that all employees of the firm be independent if the client, i.e. independence of the employee is impaired does not necessarily mean that independence of the firm is also impaired. If independence of an employee having no managerial responsibility is impaired, independence of the audit firm will be maintained by assigning the employee to other engagements. If independent of a managerial staff is affected, he/she has to be transferred to an office of the firm that is not significantly participating in the audit engagement.

Period: an auditor is required to be independent of the client during the following time period

- During the period of examination(auditing) process
- During the period covered by the financial statements
- At the time of expressing the auditor‘s opinion(the date of the report)

During these time period holding of financial interest, or a commitment to acquire a financial interest, establishing business relationships may adversely affect the auditor independence.

Financial interest: According to the interpretation of rule 101:

- A member or a member‘s firm client cannot have any direct financial interest in the client. Direct financial interest indicates any involvement in the client. Direct financial interest comprises independence. Hence firm‘s entire partners and all other professional staff that would participate in that specific engagement should not have any direct financial interest. Indirect financial interest exists when a member or a member‘s firm owns stock in a mutual fund, and/or when a member‘s non-dependent close relative has a financial interest in the client.
- A member should not have joint closely held business investment with a client company. Or officers, directors, or a principal stockholder of such enterprise that is material to either of the member‘s or the audit firm‘s net worth.
- A member is not permitted to have any loan to or from a client, or its officers, directors or principal stockholders, which is not made under normal lending, procedures, terms and requirements. This prevents any favoritism that affects or (appear to have affected) the auditor‘s independence.

The following may considered as ways of maintaining independence:

- **Training**: members should be adequately trained to help them understand the technical standards relevant to various types of professional engagement. Advice should also be given to members for specific situations.

- There should be a **controlling body that sanctions the public accounting firm** and or auditors for misconduct.
- Public accounting firms **should give much emphasis to independence** as it is the vital means of gaining reputation, and therefore there should be internal pressure that forces members to act in professional manner. Before accepting a new client public accounting firms should evaluate as the existence of threats of independence.

Rule 102 integrity and objectivity

In the performance of any professional service a member shall maintain objectivity and integrity. Integrity means being honesty or truthfulness whereas objectivity refers to members to be free of conflicts of interest and shall not knowingly misrepresent facts or subordinate his/her judgment to others.

This rule requires the members to be **free of any bias and his/her opinion should be based on facts rather than on any predetermined judgments**, and it applies to all types of professional services rendered by the CPAs.

Rule 201 General standards

A member in public practice shall comply with the following standards and with any interpretations thereof by bodies designed by council.

A. Professional competence: undertake only those professional services that the member or the member‘s firm can reasonably expect to be completed with professional competence.

B. Due professional care: members should exercise due professional care in the performance professional services.

C. Planning and supervision: a member should adequately plan and supervise the performance of professional services.

D. **Sufficient and relevant data:** a member should obtain sufficient and relevant data to afford basis for conclusion or recommendations in relation to any professional service performed. All types of professional services rendered by CPAs should be performed with competence and due professional care. Before accepting any professional engagement, CPAs should evaluate the capability to carry out the assignment according to the professional standards. For example, if the client organization has a sophisticate electronic data processing system, the firm should make sure the availability of a professional staff having detailed computer knowledge. If such a person is not available, the engagement should not be accepted since it cannot be performed completely.

Rule 202 Compliance with standards

A member who performs auditing reviewing, compilation management, consulting tax or other professional services shall fulfill with the standards circulated by bodies designated by council.

Rule: 203 Accounting principles

A member shall not:

1. Express an opinion or state affirmatively(positively) that the financial statements or other financial data of any entity are presented in conformity with GAAP, if such statements or data contain any departure from accounting principles disseminated by bodies designated by council to establish such principles that has a material effect on the statements or data taken as a whole or
2. State that he/she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with GAAP, if however the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading the member can comply with rule by describing the departure, its approximate effect if possible, and the reasons why compliance with the principle would result in misleading the statements.

An auditor should not issue unqualified opinion on financial statements unless these statements are prepared according to the principles and standards outlined by the various designated bodies like the Financial Standard Board (FASB). However, if application of the principles and standards results in misleading financial statements, the auditor should express the departure and show the effect of the departure in the financial statement.

Rule: 301: Confidential client information

A member in public practice shall not disclose any confidential client information without the specific consent of the client. Auditors, due to their profession, do have access to confidential client information. Some of such information may be of sensitive nature and may negatively affect the client, if disclosed. Hence, an auditor should not disclose any confidential client information without a written consent of the client. But this rule also requires the auditor to fulfill his/her legal and professional requirements when there is a need to disclose relevant information to third party (legal bodies) without the authorization of the client. In this case the auditor may become liable for disclosing confidential client information, if it results loss to the client, he/she may also become liable for not disclosing criminal acts of the client.

Rule: 501 Acts discreditable

A member shall not commit an act discreditable (shameful) to the profession. This rule requires auditors to avoid acts that may damage the reputation (name or status) of the profession. All acts that may create negative attitude towards to the profession cannot be mentioned. However, the following are identified by the AICPA as acts that may adversely affect the reputation of the profession.

I. Retention of client records and auditor working papers such as adjusting entries in to complete the client records.

When auditors are discharged their services, they may retain working papers to enforce payment of their fee. Since the working papers are property of the auditors such retention may not considered as unethical. But if the working papers are the only supporting documents for client‘s financial records, the auditors should give the working papers to the client after payment is collected.

II. Discrimination in employment: Employment should not be based in age, sex, color, race, or any other discriminatory acts.

III. Failure to follow standards and/or other procedures, or any other requirements in governmental audit.

IV. Negligence in carrying out duties and responsibilities

A member should carry his/her duties with care. Acting negligently reduces the quality of the professional services, which in turn would reduce the public trust and confidences.

Rule: 502 advertising and other forms of solicitation

A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion (force), over-reaching or harassing conduct is prohibited. The major points of rule 502 are:

- Members should not try to obtain work in unprofessional manner.
- Members should not make comparisons with other implying that services provided by others is of inferior in quality
- Fees for professional work should be quoted with great care
- No fees, commission or reward should be given to third party for introduction.

Rule: 503 Commission and referral fees

Prohibited commissions: a member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommends or refers any product or service is to be supplied to a client, or receive a commission when the member or the member‘s firm also performs for that client:

a. An audit or review of financial statement

b. A completion of a financial statement when the member expects. Or reasonably might expect that a third party will use the financial of independence

c. An examination of prospective financial information

This prohibition applies during the period in which the member is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in such listed services.

Disclosure of permitted commission: a member in public practice who is not prohibited by this rule from performing services or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to which the member recommends or refers a product or service to which commission relates.

Referral fees: any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client. In most cases clients consult their CPAs for advice on products or services they plan to acquire. A member shall not recommend or refer to client a product or service if the member is involved in audit reviews, or compilation or examination of prospective financial information. If the member or the members firm is not involved in the above mentioned activities, the member may receive commissions and referral fees, and should disclose the existence of the commission to the client.

Rule: 505 Form of organization and name

A member may practice public accounting in a form of organization permitted by a state law or regulation whose characteristics conform to resolution of council. A member shall not practice public accounting under a firm name that is misleading.

Rule 505 requires members of the public accounting practice not to form and operate a firm under a misleading name, regardless of whether it is formed as a professional corporation, partnership, or sole proprietorship.

In order to establish a public accounting firm as a professional corporation, the following conditions should be met:

- All shareholders must be engaged in the practice of public accounting
- The principal executive officer shall be a shareholder and director
- To the extern possible all other director & officer should be CPAs an examination of prospective financial information.

Study Note

- *The American Institute of Certified Accountant's code of ethics consists of two parts: the principles and the rules. The principles are basic frames of references for the rules. The rules govern the performances of professional services by members and are enforceable applications of the principles. There Are Six Principles of Professional Ethics and rules govern the performances of professional services by members.*

Activity

Question 2.2: Discuss about the professional ethics and code of conduct for auditors.

_____

_____

_____

2.3. Legal responsibility and Liability

An auditor has legal liability and responsibility to his/her client due to contractual obligation and to third party under the common law. An auditor becomes legally liable for breach of contract under contractual law for failure to detect embezzlement or fraud committed by client employees. The client may sue the auditor alleging (claiming) that the auditor was negligent in not detecting the scheme. The auditor will be liable if he/she is proved that the reason for not detecting fraud is his/her negligence. But the auditor may not be liable if, performed his/her duties according to GAAS and/or if the auditor proves that his/her negligence was not the main cause of the client's loss. An auditor has an obligation to exercise due professional care in rendering any type of professional service, even if this obligation is not specifically stated in the contract. Failure to exercise due professional care has two aspects: ordinary negligence and gross negligence.

Ordinary negligence: an auditor is considered to be negligent when he/she **fails to act professionally** or when he/she **fails to exercise the degree of care (unintentionally)** a

reasonable person would exercise under the same circumstances which results damages to another party.

Gross negligence: refers to **failure to exercise due professional care intentionally to deceive or uncover fraud**. The auditor may use ***contributory negligence*** (negligence on part of plain-tiff has contributed to the loss) as a defense if the client has contributed for the incurrence of losses or for the damages caused to the client by the auditor‘s negligence. The concept of comparative negligence is used by the court to allocate damages between negligent parties based on the negligent parties.

Case on Comparative Negligence: *Calvert Roth, CPA, for five years, has audited financial statement of Metro Bank, at the end of each audit, he suggested improvements in bank's internal control over consumer loans, but the bank neglected. In the last year a fraud was discovered that Harold Key, a loan officer had embezzled funds through creation of fictitious consumer loans. Bank filed the case against auditor. The judge followed principle of comparative negligence and allocate damages between bank (80) and auditor (20%).*

Auditors may become liable to third party if the third party proves that it sustained loss as a result of decisions made relying on the auditors‘ opinion, and that the auditors were guilty (accountable) of certain degree of negligence. Auditors may be sued for misleading others associating their name with professional services other than auditing. Therefore, the auditor should clearly show his/her position in such service, e.g. marking‘‘ un audited‘‘ on the financial statements compiled.

In general, an auditor may be sued for negligence for acts of others, lack of privileged information for attempting to withhold information that is not privileged, or for not discharging his/her legal responsibilities mentioned under rule 301. Auditors may also be held liable for failure to apply GAAS or GAAP, for not reviewing events subsequent to balance sheet date, and for not disclosing information that may have material effect on the financial statements. Moreover, auditors have legal liability to their colleagues, to potential investors, to creditors, financial institutions, to the government, and to any stakeholders of the audited financial statements in giving honest information.

The degree of negligence required to establish the auditors‘ liability varies from one jurisdiction to another. There are three general approaches;

Ultra mares: under this, CPAs are held responsible for ordinary negligence only to the third party beneficiaries. Other third parties must prove gross negligence on part of the auditors.

Illustrative Case (Ultra mares and Touché Co. (1931)*: auditors issued unqualified opinion (Clean opinion) on balance sheet of a company. On this basis, Ultra mares made loans to a company. Later a company was declared bankrupt. Ultra mares sued auditors for ordinary negligence.*

Restatements of Torts: under this liability for ordinary negligence to third parties is extended to include any limited class of parties that could be foreseen to rely upon financial statements.

Illustrative Case: Dianne Holiday, CPA, performed audit for Lyman Corporation. Lyman intended to use audit report for bank loans, but no specific bank name mentioned. First national bank and Dime Box State bank gave loans and also Wallace Manufacturing Company provided trade credit. Lyman Corporation declared bankruptcy.

Decision: Banks form a limited class of third party. Wallace Company should prove gross negligence.

Rosenblum: it extends the auditors liability for ordinary negligence even further to include any third party, the auditor could reasonably foresee as receipts of the financial statements.

Illustrative Case: Rosenblum and Adler case (1983): auditors issued an unqualified report on the financial statement of Giant Store Corporation. Rosenblum sold a showroom business for shares of Giant stock to Giant Store Company. Giant became bankrupt. Rosenblum sued auditors for ordinary negligence. The trial dismissed the case, but New Jersey Supreme Court reversed lower court decision. It extended auditor’s liability to other third parties which can be reasonably foreseen.

Study Note

- *An auditor has legal liability and responsibility to his/her client due to contractual obligation and to third party under the common law.*
- *An auditor becomes legally liable for breach of contract under contractual law for failure to detect embezzlement or fraud committed by client employees.*
- *The client may sue the auditor alleging (claiming) that the auditor was negligent in not detecting the scheme.*
- *The auditor will be liable if he/she is proved that the reason for not detecting fraud is his/her negligence. But the auditor may not be liable if, performed his/her duties according to GAAS and/or if the auditor proves that his/her negligence was not the main cause of the client's loss.*

Activity Question 2.3: *Describe the legal liability and responsibilities of auditors and indicate scenarios in which auditors may be liable.*

_____

_____

_____

2.4. The auditing profession: Views on the Ethiopian Experience

In Ethiopia, auditors are liable to the client and third party for losses they cause in exercise of their and punishable in accordance with the penal code.

Article 380 of the commercial code of Ethiopia (1960) states that:

1. Auditors shall be civilly liable to the company and third parties for any fault in the exercise of their duties that occasioned loss.
2. An auditor who knowingly gives or confirms an untrue report concerning the position of a company or fails to inform the public prosecutor of an office, which he knows to have been committed, shall be punished under Article 438 or Article 664 of the penal code as the case.

The civil liabilities of the auditor arise if he/she has caused a loss to his/her clients through his/her negligence or non-performance. These liabilities are governed under the contract provisions of the commercial code.

Art. 2031 of the civil code, which addresses professional default, states the following;

(1) A person practicing a given profession or activity shall in the practice of such profession or activity observe the rules governing that practice.

(2) He/she is liable where after due consideration of scientific data or rules recognized by the practitioners of his/her profession, he/she appears to be guilty of imprudence or negligence constituting definitive disregard of duty.

Study Note

- *In Ethiopia, auditors are liable to the client and third party for losses they cause in exercise of their and punishable in accordance with the penal code.*
- *According to Article 380 of the commercial code of Ethiopia, auditors shall be civilly liable to the company and third parties for any fault in the exercise of their duties that occasioned loss and knowingly gives or confirms an untrue report concerning the position of a company or fails to inform the public prosecutor of an office, which he knows to have been committed, shall be punished under Article 438 or Article 664 of the penal code as the case.*

Activity

Question 2.1: *Discuss situation under which auditors are liable in Ethiopia.*

_____

_____

_____

Chapter Summary

This chapter covered the basic codes of professional conduct, which the auditors need to bear in mind in carrying out their duties. The main source of material for code of professional conduct in this unit is the AICPA‘s code of professional ethics. Standards are established to measure the quality and performance of individuals and organizations. Standards relating to the auditing profession concern themselves both with the CPA‘s professional qualities and with the judgment exercised by CPA‘s in the performance of their professional engagement. Our purpose in this topic is to make clear the nature of generally accepted auditing standards (GAAS). In our

discussion of GAAS, we consider mainly on the nature of the independent auditor‘s report. The existence of GAAS is evidence that auditors are very concerned with the maintenance of a uniformly high quality of audit work by all independent public accountants. GAAS consists of

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standard of field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of test to be performed.
3. A sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford reasonable bias for an opinion regarding the financial statements under audit.

Standard of Reporting

1. The report shall state whether the financial statements are presented in accordance with GAAP.
2. The report shall identify those circumstances in which such principle have not been consistently observed in the current period in relation to the preceding periods.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expended.

Glossary of Terms

Profession is a specialized body of knowledge that provides intellectual services to the best interest of the public and which has gained public confidence and trust.

Ethics consists of moral principles and standards of conduct imposed by a profession on its members.

Chapter Review Questions 2

Part I: Write ''TRUE'' if the statement is correct and ''FALSE'' otherwise.

1. Auditors have legal liability and responsibility to the stakeholders in particular and to the public in general.
2. The difference between gross and ordinary auditors' negligence is that the latter may happen due to their deliberate act.
3. The need to maintain independence in mental attitude in all matters pertaining to the audit is standards of field work.
4. A CPA firm is reasonably assured of meeting its responsibility to provide services that conform to professional standards by adhering to generally accepted auditing standards.
5. An auditor should maintain an objective and impartiality in his/her audit engagement; this implies objectivity.

Part II: Choose the correct answer for the following multiple choice questions.

1. All of the following are the dilemmas faced by professionals to give priority for public interest than personal , except
   A. Financial relationship
   B. Family relationship
   C. Friendly relationship
   D. All of the above
   E. None of the above
2. ----------refers to the awareness or consciousness of auditors at the time of discharging their duties and responsibilities.
   A. Integrity
   B. Scope of the audit
   C. Due care
   D. Public interest
   E. None of the above
3. Of the following one is unique from others, identify
   A. Planning the audit

B. Understanding the client‘s internal control system

C. Obtaining sufficient & reliable audit evidence

D. Due professional care

E. None of the above

4. A principle that states ―*A member should observe the profession technical and ethical standards, strive continually to improve competence and quality of service*‖ is;

   A. Due care

   B. Public interest

   C. Responsiveness

   D. Independence

   E. Integrity

5. The need for professional ethics arises out of the following, **<u>except</u>**:

   A. Responsibility to serve the public

   B. Complex body of knowledge

   C. Standard of admission to profession

   D. The need for public confidence

   E. None of the above

Chapter 3: Planning and Conducting the Audit

Dear Learners!

As we have discussed in the earlier chapters, the audit work should be performed by person or persons having adequate training and skill about the audit procedures. The audit procedures have various stages or phases. Auditors are responsible to do different tasks fairly and independently during these various phases of audit process. The three major phases of the audit work are planning the audit work, performing the field work of auditing, and reporting audit findings.

Objectives of the Chapter: After completing study on this chapter, you are expected to;

1. Discuss reasons for Audit planning
2. Describe audit planning procedures
3. Understand Designing of Audit program
4. Prepare audit working paper
5. Discuss about audit risk
6. Discuss about materiality in auditing

3.1. Reasons for Audit Planning

Audit planning is the process of determining an overall strategy for the conduct and scope of the engagement. There are many reasons for planning the audit work. Some of them are discussed below.

- To enable the auditors to obtain sufficient and competent evidence for the circumstance
- To keep reasonable audit cost. If the organization is complex, senior auditors are required and high cost will be incur to perform the audit work. On the other hand if the organization is small, junior auditors are required and less cost will be incur.
- To avoid misunderstanding with the client
- To complete the audit work based on the schedule
- To assign assistant, if any.

3.2. Audit Planning Procedures

As per Auditing and Assurance Standard 1, ―Basic Principles Governing an Audit‖, Audit Planning is one of the basic principles. Accordingly, it states the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based

on knowledge of the client‘s business. Plans should be made to cover, among other things acquiring knowledge of the client‘s accounting systems, policies and internal control procedures; establishing the expected degree of reliance to be placed on internal control; determining and programming the nature, timing, and extent of the audit procedures to be performed; and coordinating the work to be performed. Plans should be further developed and revised as necessary during the course of the audit

Audit planning process includes:

A. Pre-plan
B. Obtained back ground information
C. Obtain information about client‘s legal documents
D. Develop overall audit programs
E. Schedule the audit work
F. Assigning professional staff to engagement.

1. Pre-plan: before planning the audit work, auditors should do two things:

i. Client acceptance (accept or reject the audit contract)

ii. Obtain an understanding with the client

Auditors should avoid clients who lack integrity. That is auditors should evaluate public image, financial stability, relationship with the previous auditors of a new client. To do this, the auditor should read the past financial statements of the client, contract with past and present business associates like banks and attorneys, by discussing with the potential client the need for the audit, and by contacting the potential client‘s former auditors with the consent of the organization. If there are no serious doubts raised about the integrity of the client, then the auditor will sign to close a deal. The audit contract is called an Engagement Letter. The audit engagement letter includes the following expressed duties:

- ✓ The nature of the work to be performed
- ✓ The dead line of the audit contract
- ✓ The amount of the audit fee
- ✓ Limitations of the auditor with respect to detection of errors, irregularities, and illegal acts.

2. Obtaining background information

Auditors should have feedback about the client‘s unique accounting requirements, the possibility of risk, and the controlling system on its assets. Different forms of enterprises require different

accounting requirements. For instance, if the client is Construction Company, percentage of contract completion is applied or required to recognize revenue. On the other hand if the client is government organization, government accounting is used. Thus, the auditor should identify the client‘s accounting requirement and follow appropriate audit procedures at times when he/she performs the audit work. The possibility of risk also varied from client to client. That means the chance of occurring errors, irregularities, illegal acts, and misuse of cash or other resources may vary from one organization to the other. In order to adjust or aware themselves about their future activities, auditors should get feedback about the problems of the client.

Finally, the auditor should tour (observe) the client‘s personnel and assets controlling technique. For example, if the auditor sees the store keeper sleeps at his/her desk with the store door open, or the casher talking on the phone while he/she is counting money, there will be the sign to weakness in the client‘s internal control system. Or if the auditor sees broken or obsolete equipment, that might be the signal that plant assets are possible overvalued.

3. Obtaining information about the client’s legal documents

There are three documents of the client that should be observed by the auditors. Examining these documents and records enable auditors to enter prate related evidences during their engagement. The three legal documents are discussed below.

i. Corporate charters and by laws
ii. Minutes of meetings
iii. Contracts

i. Corporate charters and by laws: the corporate charter is granted by the government in which the company is incorporated. It includes name, address, date of establishment, types of business activities, voting right, dividend allocation systems, etc. By laws include rules and regulations adopted by the organization in order to accomplish different activities of the organization.

ii. Minutes of meetings: are the official records to the meetings of the management and higher body of the organization. These minutes of meeting include the management decision such as compensation of officers, bonus rates, dividend rates, etc.

iii. Contracts: clients may enter in to different contracts to others like pension plans, contracts with suppliers, government contracts with completion and delivery of manufacturing products, lease, etc.

In general, if the auditor have information about the three legal documents of the client before starting his/her main task, he/she will be aware and inform about such information while examining and evaluating the difference evidences of the client and finally he/she is adequate to give suggestion and recommendation in his/her final report.

4. Develop overall audit report

An audit program is the detailed list of the audit procedures to be pertained by the auditor in examining the financial statements. Before starting the work, the auditor should ordinarily establish a preliminary program for a review this audit program should be documented in a manner that will permit the auditor to record completion of the audit work and identify work that remains to be done. As the work progresses, the auditor should evaluate the adequacy of the program based on information gathered during the audit. The audit program may be modified if the auditor believes that the planned procedures are not sufficient. The objectives of preparing audit program are:

- To assist in planning the audits so that efficient and effective procedures are applied in accordance with the audit strategy
- To provide clear instruction to staff as to the nature, extent, and timing of the audit work.
- To provide a record of the work done and the conclusions drawn, as a basis for effective quality control and to meet audit evidence requirements.

An audit program has two major sections.

a. **The system section:** this section of the audit program focuses on the procedures used to evaluate the effectiveness of the internal control structure and it is organized around major transactions cycles of the internal control structure.
b. **The substantive test section:** this section deals with the procedures for substantive testing of financial statement amounts and the adequacy of financial statement disclosures. Besides this section of the audit program is organized in terms of major financial statement items.

5. Scheduling the audit work

Auditors should plan or forecast the beginning and ending of the audit work. In order to complete based on the established time in advance. One of the completeness of the auditors is measured whether they complete their work based on the stated time in the contract.

6. Assigning professional staff to engagement

The final phase of planning of the audit work is assigning of professional staff to engage the audit work. As we have been discussed earlier, the audit work should be done by those having

sufficient skill. Assistance should also assign, if necessary. Once the auditor is clear about the objectives and internal control system of the client, he/she has to collect and evaluate relevant evidence for his/her audit work through different techniques. These various ways of evidence accumulation techniques are discussed below.

A. Physical inspection: the auditor may physically inspect the actual existence of certain assets. For instance, the auditor may count cash box, observe the physical handling of inventories though it is not necessary that handling of inventories means ownership because goods may be handled on behalf of the others.

B. Examination of documents: the auditor may collect relevant data by examining related documents. Thus, the auditor who wishes to verify the payment of cash for any reason may examine or test checks stubs, for purchase of merchandise on account he/she may verify purchase invoice, for receipts of cash from any source the auditor may check receipt stubs, and so on. Examination of documents can be performed through:

i. Vouching: examining documents started with the recorded transactions (journals, ledger, F/S) back to source documents, called test of occurrence.

ii. Tracing: determining whether source documents have been properly recorded in the accounting record, called of completeness.

iii. Scanning: verifying documents through quick or selective reading of the recorded documents of the client.

iv. Mechanical accuracy: are checks of work performed by others such as verifying client computations of the balance of accounts. For example, re calculating the balance of A/P, A/R, cash, etc.

C. Questionnaires (Inquiry): the auditor also can collect relevant information through preparing questionnaires. The auditor may obtain primary data (from those related persons e.g. employees) or secondary data (from unrelated persons e.g. outsiders) about certain information.

D. Confirmation letter: the auditor may obtain evidences through confirmation from the third parties such as banks, debtors, and creditors about the balance of some accounts. There are two confirmation letters- positive and negative.

i. Positive confirmation letter: is prepared when the client asks his/her or its business associates such as banks, creditors, or debtors to give response to the auditor whether or not the balance of the concerned account is similar. For instance, the client may ask the

creditor about the similarity or difference in the balance of Accounts Receivable and a response to the auditor for the auditor‘s address.

ii. **Negative confirmation letter:** is prepared when the audited organization asks its business associates to give a response to the auditor **only** if there is difference in the balance of accounts.

E. **Analytical review:** the auditor can compute significant ratios, carryout a trend analysis or compare and contrast different accounting data in order to gather necessary evidence for his/her audit task. The comparison may be between current and past data, current and anticipated (budgeted) data, company information and industry average, or current information with current information.

3.3. Designing of Audit program

The success of audit plan depends on sound and solid audit Program. An audit plan is the Auditor‘s plan of action. The audit Program is specially designed for each audit is a plan of the work of examination and a set of audit procedures. A written audit Program begins with the recognition of specific objectives followed by specification of procedure design to produce sufficient competent evidential matter. An audit Program acts as a guide to arrange and distribute the work and also to check work against the possibility of omissions. Auditor should first prepare the preliminary audit Program for compliance testing of internal accounting control systems and substantive testing of accounting balance. After obtaining a thorough understanding of the client‘s business, the auditor formulates an overall audit strategy for the engagement at hand.

Types of Audit Program: Following are the two types of audit Program –Fixed AND Flexible

Fixed Audit Program − Audit staff has to follow the instructions mentioned in the Audit Program as laid down in it without any change. Even all are not applicable to that particular organization in a particular situation. Fixed audit Program is very rigid in nature and any modification or change is Program is not easily possible.

Flexible Audit Program − Flexible Audit Program gives only the outline of the scope and the procedures to be followed instead of any fixed audit instructions. Therefore an Auditor has a choice to develop, adopt and modify an Audit Program as per the needs and requirements depending on the internal control system and other situations of that particular organization.

Advantages of Audit Program

The following are the advantages of audit Program;

- Audit Program gives complete coverage of audit work that can be performed by the audit staff.
- Audit Program works as a road map for the upcoming years and the audit staff can refer to this and understand the future course of action.
- Audit Program enhances the efficiency of the audit assistants as they are very clear about their duties.
- Audit is more systematic through audit Program.

Disadvantages of Audit Program

The following are the disadvantages of audit Program −

1. It is not of great help to small business units.
2. Audit becomes mechanical and inefficient audit assistant may also take shelter behind the audit Program.
3. Audit Program cannot be applied in uniformity to all business units as audit work of all organization cannot be the same.

Generally, auditors perform auditing based on the following steps:

1. **Engagement** - When a new client hires an auditor, the auditor first examines the client company. The auditor studies the company's ethical background and history. Successful auditors are always associated with ethics and professionalism. It is foolish for an auditor to work for a client that has ethical issues in the past. Auditors also ensure that they are totally independent from the client before accepting them. If the auditing firm has a partner that was once a manager in the company, for example, if the audit firm and the company are related, there might be serious independence issues. Once the auditor decides to accept the client, he drafts an agreement stating the terms of the audit and other details, such as remuneration.
2. **Understanding the company** - Auditors study the industry and business environment of the company. Auditors must understand how the business works, the procedures of the company, and so on.
3. **Assess risks** the auditor assesses the risks of the company, and decides on what is considered material or immaterial.
4. **Develop audit plan** the auditor finally plans which areas of the business he will focus on and how much time will be spent for the audit.
5. **Collect evidence and test internal control systems** - The auditor starts collecting evidence to verify the financial records, using a wide range of tools. It might involve interviews,

observations, tests, calculations, confirming with a professional expert on some area, and so on. Auditors also review and conduct the company's internal control system. A good and proper internal control system probably means that proper financial records will be produced.

6. **Conclusion and issuance of the auditor's report -** The auditor issues his / her conclusion in the auditor's report based on the findings objectively.

3.4. Audit Working Paper

During the course of audit, auditors should maintain all relevant documents and records in the form of both hard and soft copy called **audit working papers**. Audit working papers are those papers which contain essential facts about accounts which are under audit. The audit working papers contains the file of all analysis, summaries, comments, and correspondence built up by the auditors during the course of the fieldwork of an audit engagement. It is the duty of auditors to maintain audit working papers as they support the audit report.

The audit working papers provide the following purposes to the auditor:

a. To show the extent to which accounting principles and auditing standards have been adhered.
b. To provide essential support for the auditors‘ opinion including evidence that the examination was conducted in accordance with GAAS.
c. To reveal how the work was performed by the audit staff and thus helps to the auditors in forming an opinion about their efficiency.
d. To assist auditors in justifying their position against criticism and can be serve as legal evidence if the legal action is brought against the auditors due to negligence in performing the audit work.
e. Help auditors in finalizing the audit report without much delay.
f. They enable the auditors to know the weakness of the internal check system in operation and the inefficiency of the accounting system, if any. The auditors may advice to their client about ways and means to improve inefficiencies.
g. They serve as a guide to the auditors for audits of the same client in the succeeding years.

Working papers should be carefully prepared as they are the bases of conclusions and summarizations shown by the auditor in his/her report. As such, they should be clear and

significant matter which require strategic judgment together with the auditor‘s conclusions complete and contain all essential information sufficiently so that they may be of greater utility. Each complete working paper should be signed and dated by the persons performing the work. This will help in fixing responsibilities. They should be properly organized, arranged, and documented.

General working paper preparation guidelines

- Working papers must be clean, neat, and legible
- All questions and exceptions noted in the working papers should be resolved, hopefully before the end of the field work, and carefully before the report is issued.
- Only statements of fact and professional judgment should appear on the working papers.
- Brackets should be used to show negative numbers instead of red ink.
- Time should be economized as much as possible in the preparation of working papers. This can be achieved by assigning some work papers to be prepared for the auditor By the Client‘s employee /PBC/, which are then examined by the auditor. Another way to save time is by analyzing balance sheet accounts and their related income instatement accounts together on the same work paper.

Working papers should be stored/filed/ in a secure place and protected from unauthorized use. Current technology allows for working papers to be stored electronically on computers, CDS, flash, etc. Working papers should be stored for as long as the auditor has a potential liability for the financial statement opinions, which the work papers support. The Ethiopian commercial code of 1960 requires that organizations, which come under its rules, keep books of accounts and accounting documents for ten years after the last entry.

Ownership of working papers

A pertinent question arises as to whom the owner of these working papers. The auditor claims the possession on grounds that he/she has collected the information for the purpose of discharging his/her duties. He/she further argues that if a suit is being filed by the client against him/her for negligence in the performance of his/her duties, these working papers can be furnished as evidence to show the exact work done by him/her. These papers can be produced by the auditor to defend him/her. As such, these working papers should not be handed over to the client even after the audit ceased. On the other hand, the client claims that since the auditor act as its agent, he/she has no right to keep these papers with him/her. However, they also permit to see the following cases to solve these controversies. In the first case, it was held that the working

papers belonging to the auditor because they were independent contracts and not agent of the client. In the second case, it was held that the working papers prepared by the auditor for the sole purpose of producing financial statements belonged to the auditor and not to the client. It can therefore, be concluded that the working papers prepared by the auditor or his/her staff to carry out the assignments are his/her property and the client has no claim on such papers.

Finally, audit working papers are confidential in nature. The information collected by the auditor or his/her staff should not be exposed to any unrelated party other than his/her client without the consent of his/her client or otherwise than as required by any law for the time being in force. Thus the auditor should always impress up on his/her staff to maintain complete secrecy with regard to the working papers.

3.5. Audit Risk

In the audit planning process, the auditor should ordinarily established levels of planning materiality such that the audit work will be sufficient to meet the audit objectives and will use audit resources efficiently. For example, in the review of an existing system the auditor will evaluate materiality of the various components of the system in planning the audit program for the work to be performed. The auditor should consider both qualitative and quantitative aspects in determining materiality. The main purpose of an audit is to express an opinion on the truth and fairness of the financial statements. The concept of materiality affects the nature and size of audit tests. The auditor designs audit procedures to verify if financial statement items are free of material error and irregularities. If financial statement audit, due to cost and time only selected transactions are examined, this implies accepting errors in the financial statements to remain undetected. However, even 100% checking does not guarantee 100% accuracy. Therefore, either the whole transactions or selected transaction are checked, there is certain level of risk. Thus, the auditor‘s main concern in the financial statement audit is to minimize risk and to ensure that no material error remains undetected.

An assessment of risk should be made to provide reasonable assurance that all material items will be adequately covered during the audit work. This assessment should identify areas with relatively high risk of existence of material problems. Audit risk is the risk that the auditor will issue an inappropriate opinion on the accounts. Or it is the risk that the auditor gives unqualified

opinion on the financial statements when he/she should have qualified opinion on the financial statements when he/she should have qualified opinion.

It is the chance that material misstatements exist in the financial statements and the auditors do not detect the misstatements with their audit procedures. Audit risk is the chance that:

I. A material misstatement in an assertion has occurred and
II. The auditors do not detect the misstatement

Audit risk has three components namely inherent risk, control risk, and detection risk.

Inherent Risk: refers to the susceptibility of an account balances to material error assuming the client does not have any related internal controls.

Control Risk: is the risk that a material misstatement in an account balance will not be prevented or detected on a timely basis by the company‘s internal control.

Detection Risk: is the risk that auditor‘s procedures for verifying account balances will not detect a material error when in fact such error exists. It is the risk that the auditor‘s procedures will lead them to conclude that a material misstatement does exist. Therefore, detection risk is directly related to the effectiveness of the auditor‘s procedures. While inherent and control risk are functions of the client and its environment. In planning the audit, the auditor should assess the extent of inherent and control risk and then plan relevant audit procedures to the effectiveness of the auditor‘s procedures. In planning the audit, the auditor should assess the extent of inherent and control risk and then plan relevant audit procedures to reduce detection risk to the level tolerable. This turn helps auditors to reduce the overall audit risk so as to issue an appropriate opinion.

3.6. Materiality

Materiality and audit risk are related both must be considered in the planning stage so as to determine the extent, timing, and nature of the examination. For planning purpose, materiality is the auditor‘s preliminary estimate of the smallest amount misstatements that would affect the judgment of a reasonable person relying up on the financial statements. Assessing the level of materiality of misstatement would help auditors to appropriately modify their opinions whenever there are material deficiencies in the client‘s financial statements. However, they may issue unqualified report if the deficiencies are immaterial. Assessing level of materiality of misstatements in the financial statement items means evaluating as to whether the financial statements contain material misstatements or not.

Chapter Summary

Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit. The auditor should develop and document an audit plan that includes a description of the planned nature, timing, and extent of the risk assessment procedures; the planned nature, timing, and extent of tests of controls and substantive procedures and other planned audit procedures required to be performed so that the engagement complies with standards.

Glossary of Terms

Audit Plan is the specific guideline to be followed when conducting an audit.

Audit program a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statement of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Audit Risk (also referred to as residual **risk**) refers to the **risk** that an **auditor** may issue an unqualified report due to the **auditor's** failure to detect material misstatement either due to error or fraud.

Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision making of users.

Audit working paper the documents which record during the course of audit evidence obtained during statements auditing, internal management auditing, information systems auditing, and investigations and used to support the audit work done in order to provide the assurance that the audit was performed in accordance with the relevant auditing standards.

Chapter Review Questions 3

Part I: Write ‘’TRUE’’ if the statement is correct and ‘’FALSE’’ otherwise.

1. Auditor must adequately plan the work and must properly supervise any assistants, obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements.

2. Audit program refers to the detail list of the audit procedures during the audit time.
3. According to the field work standards of GAAS, the audit work shall be done arbitrary.
4. Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision making of users.
5. Audit risk refers to the risk that an auditor may issue an unqualified report due to the auditor's failure to detect material misstatement either due to error or fraud.

Part II: Choose the correct answer for the following multiple choice questions.

1. The audit working papers provide the following purposes to the auditor, except;
   A. To show the extent to which accounting principles and auditing standards have been adhered.
   B. To reveal how the work was performed by the audit staff and thus helps to the auditors in forming an opinion about their efficiency.
   C. They enable the auditors to know the weakness of the internal check system in operation and the inefficiency of the accounting system, if any.
   D. They serve as a guide to the auditors for audits of the same client in the succeeding years.
   E. None of the above
2. All of the following are the audit planning process except:
   A. Obtained back ground information
   B. Obtain information about client‘s legal documents
   C. Schedule the audit work
   D. Assigning professional staff to engagement.
   E. None of the above
3. The chance that material misstatements exist in the financial statements and the auditors do not detect the misstatements with their audit procedures is;
   A. Audit Risk
   B. Audit plan
   C. Materiality
   D. Detection risk
   E. All of the above

4. The detailed instruction for the collection of a type of audit evidence that is to be obtained at some time during the audit is;
   A. Audit planning
   B. Audit program
   C. Audit strategy
   D. Audit Procedure
   E. None of the above
5. The objectives of preparing audit program are:
   A. To assist in planning the audits
   B. To provide a record of the work done and the conclusions drawn.
   C. Serve as a basis for effective quality control and to meet audit evidence requirements.
   D. All of the above
   E. None of the above

Chapter 4: Internal Control

Dear Learners!

Internal control is another important area of auditing. Internal control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working. Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organization. These days business has been become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate. The Internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business. In this unit you will learn the meaning and objectives of internal control, discuss about basic elements of internal control system and limitation of internal control.

Objectives of the Chapter: after completing study on this chapter, students are able to:

1. Understand the meaning of internal control.
2. Understand objectives of Internal Control system.
3. Identify types of internal control.
4. Describe the control environment.
5. Understand Control Procedures.
6. Describe the accounting control System.
7. Identify elements of Sound Internal Control System.
8. Explain limitation of Internal control

4.1. Meaning of Internal Control

Definition of internal control, as published by the accounting profession is in 1949 and Statements on Auditing Standards (SAS) No. 1 (paragraph 320.09), states; Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

Internal control is also defined as: A process effected by the entity‘s board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ✓ Effectiveness and efficiency of operations
- ✓ Reliability of financial reporting, and
- ✓ Compliance with applicable laws and regulations. (Whittington & Pany; 1997:364)

The other definition for internal control is stated in the opening paragraph of Auditing Standards and Guidelines is: The whole system of control, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the record.

The American Institute of Public Accountants has defined internal control as the plan of organization and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments. The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records". In the best broad sense an organization organizational structure (also referred to as internal control system) consist of the policies and procedures establish to provide reasonable assurance that the organization objectives will be achieved. For the purpose of auditors, internal controls may be defined as all the policies and procedures a company uses to prevent, detect, and correct material errors, irregularities and misstatements that might get into financial statements.

The following are the major reasons for evaluation of internal control:

1. To give the internal auditor a base for planning the audit and to determine the nature, timing, and extent of audit procedure.

2. To formulate constructive suggestion for improvement in the organizational internal controls deficiencies such as:
    - ✓ Absence of appropriate segregation of duties
    - ✓ Absence of appropriate reviews and approval of transactions
    - ✓ Evidence of failure of control procedures by persons in authority to the detriment of control objectives.
    - ✓ Evidence of willful wrong doing by employees or management including manipulation, falsification or alteration of accounting records.

If we analyze the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management. Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. An internal control structure of an organization bas four objectives; these are:

1. To safe-guard the assets and records of the organization
2. To ensure the accuracy and reliability of the accounting data and information.
3. To promote efficiency in all the organizations operations.
4. To encourage adherence to managements prescribed policies and procedures.

In achieving these objectives, the internal control structure applies such controls as comparison of actual measures against benchmark for instance, the actual cash on band and in the bank should equal the amount deflected in the cash ledger account and signature on a check should match the name of the person authorized to sign.

For any type of transaction in a client‘s system several types of recording errors (misstatement) can occur. Payroll transaction for example, can be in error if the wrong number of hours was charged on the time card or gross payroll was debited to the wrong account number in the payroll journal. Specifically, there are seven detailed objectives that internal control structures most meet to prevent errors in the journal and records:

1. *Validity:* recorded transactions are valid.
2. *Authorization:* Transactions are property authorized.
3. *Completeness:* Existing transactions are recorded.
4. *Valuation:* Transactions are properly valued.
5. *Timing*: transaction is recorded at the proper time.
6. *Classification*: Transactions are properly classified.
7. *Posting & summarization:* Transactions are properly included in the master files and correctly summarized.

Study Note

Internal control is a process effected by the entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations, Reliability of financial reporting, and Compliance with applicable laws and regulations.*

Four objectives of internal control system of an organization are;

- *To safe-guard the assets and records of the organization, to ensure the accuracy and reliability of the accounting data and information, to promote efficiency in all the organizations operations, to encourage adherence to managements prescribed policies and procedures.*

Activity

Question 4.1: *Discuss about the concept and objectives of internal control.*

_____

_____

_____

4.2. Internal Control and Internal Audit

The COSO defined Internal Control as ―a process, effected by an entity's board of directors, management and other personnel, designed to provide ―reasonable assurance regarding the achievement of objectives in the following categories: operations, reporting and compliance‖. A part of the philosophy in this definition purports that the internal control can never be limited to financial and accounting activities only since it covers all aspects of the organization and

encompasses all levels of employees, the executive management and the board of directors. The internal control is a preventive tool employed to maintain effectiveness and efficiencies of operations including financial and operations performance objectives, and protection of assets against loss, produce reports with reliability, and compliance with deadlines, transparency and any other requirements set by the organizational authorities, regulators or recognized standard setters or set forth in the organization‘s policies and compliance with laws and regulations governing the organization‘s business.

The Institute of Internal Auditors (IIA) defines the internal audit as: ―An independent, objective assurance and consulting activity designed to add value and improve an organization‘s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes‖. Further, the Association of Chartered Certified Accountants (ACCA) defines the internal audit – the control of controls – as the independent and objective evaluation of an organization‘s internal controls to effectively manage risk within its risk appetite. It is worth mentioning that the internal audit activity is carried out by an organizational unit reporting to the audit committee, which in turn reports to the board of directors. The internal audit function develops an annual action plan, which should be approved by the audit committee, and submits periodic reports on the internal audit activities.

It should be also noted that the internal audit report shall contain a section on the review and evaluation of the internal controls, and assurance of its adequacy or requirement to introduce further controls, which achieve an adequate level of internal control. The internal audit is a detective tool employed to verify the extent of executive units‘ compliance with established controls.

In light of the above highlights of internal control and internal audit, it clear that there is a complementary relationship where the internal control establishes the controls based on which a business entity should be managed while the internal audit represents a detective activity, which verifies the implementation of internal controls. This complementary relationship is further confirmed by the matching objectives of internal control and internal audit as both disciplines are ultimately intended to protect the shareholders – the entity‘s owners

4.3. Components of Internal Control

Internal control system varies significantly from one organization to the other because of many factors such as:

- The size of the entity
- The characteristics of the organization and ownership
- The nature of the business
- Diversity and complexity of its operation
- Methods of processing data
- Legal and regulatory requirement

The following are the five major components of internal control system. These are the control environment, risk Assessment, control procedures/activities, the accounting system and monitoring. The internal control system is a dynamic and integrated process in which each of the five components described impact the effectiveness of the other components.

Control Environment

The control environment is the collective effect of various over all factors that establish, enhance, or mitigate the effectiveness of specific control policies and procedures. In other words, it is the client‘s environment (internal as well as external) within which controls exist or operate. The flow of hierarchy in the organization may be upward, downward or both. It includes the **attitude, awareness, and actions** of the board of directors, management, owners, and other parties in controlling the firm‘s overall situations. The following are factors that affect the internal control environment.

V. Management philosophy and operational style: managers differ in both their philosophies towards financial reporting and their attitudes towards business risk.

VI. Organizational structure: a well-designed organizational structure provides a basis for planning, directing, and controlling operations. A sound organizational structure of an entity should separate responsibilities for authorization of transactions, record keeping of transactions, custody of resulting assets, and execution of the operation.

The responsibilities for financial matters and operating problems should be given to two separate departments namely finance and accounting departments respectively. While the finance

department conducts financial activities, the accounting department establishes accountability through accounting record.

VII. Personnel policies and procedures: the effectiveness of an internal control structure is affected by the characteristics for hiring, training, evaluating, promoting, and compensating employees.

VIII. Method of assigning authority and responsibility:

- The effectiveness of method of communicating employees‘ authority and responsibilities (job description) including the organization‘s rules and regulation affects the quality of the organization
- Having sound organizational policies related to such matters as acceptable business practices, conflicts of interests and codes of conduct
- Very effective methods of assignment of authority and responsibility will reduce the likelihood of irregularities that may result in a significant misstatement in financial statement figures.

IX. Management control method

- ✓ Management control methods are used to exercise control over the authority delegated to others
- ✓ One good example is developing plans and monitoring the process toward accomplishment of those plans: budgeting and control system and variance analysis.

X. Internal auditing

- ❖ Another component of the internal control environment is an internal auditing staff or unit.
- ❖ Internal auditors investigate and appraise the internal control structure and the efficiency with which the various units of the business are performing their assigned functions, and report their findings and recommendations to top management.
- ❖ The amount and quality of work done by internal auditors are important considerations to external auditors in assessing the control environment of a firm.
- ❖ The effectiveness of the internal audit unit of an organization mainly affected by factors such as its authority, the qualification of its staff, and the resources made available it.

Risk Assessment

A risk is anything that endangers the achievement of an objective. The risk assessment process is used to identify, analyze, and manage the potential risks that could hinder or prevent an agency

from achieving its objectives. Risk increases during a time of change, for example, turnover in personnel, rapid growth, or establishment of new services. Other potential high risk factors include complex programs or activities, cash receipts, direct third party beneficiaries, and prior problems. COSO‘s updated internal control framework identifies four principles associated with risk assessment. These are;

- Management should define objectives and risk tolerances.
- Management should identify, analyze, and respond to risks related to achieving the defined objectives.
- Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
- Management should identify, analyze, and respond to significant changes in the internal control system.

Control Activities

In addition to the control environment and the accounting system, management establishes other control over the entity‘s transactions and assets. Control procedures that can be implemented by a firm may be categorized as procedures for:

1. Proper authorization of transactions and activities
2. Appropriate segregation of duties
3. Adequate documentation and recording of transactions and events.
4. Effective safeguards over access to and use of assets and records access controls,
5. Independent checks on performance and proper valuation of recorded amounts

1. Authorization of Transactions

Authorization of transactions may be either general or specific. General authorization occurs when management establishes criteria for acceptance of a certain type of transaction such as quantity discounts. Specific authorization occurs when transactions are authorized on an individual basis (e.g. sale of a major asset).

2. Segregation of Duties

- A functional concept of internal control is that no one department or person should handle all aspects of a transaction from beginning to end.
- No one department or individual should perform more than one of the functions of authorizing transactions, recording transactions, and maintaining custody over assets.

3. **Adequate Documentation**

- A system of well-designed forms and documents is necessary to create records of the activities of all departments like use of serial numbers for business documents or preparing documents in different colors.
- Adequate safeguarding and numerical control should be maintained at all times for unused pre numbered documents.

4. **Safeguarding of assets and records**

Physical access to assets and important records, documents, and blank forms should be limited to authorized personnel. Limit access to assets such as cash inventory and securities, cost documents and account receivable records, and blank forms like a blank checks, blank sales invoices and shipping orders. Generally, direct physical access to assets may controlled through the use of safes, locks, fences, guards, surveillance cameras, and security codes and so on.

5. **Independent checks on performance and proper valuation**

- The accuracy of the work of various individuals in a company may be verified by independent checks on performance and valuation such as clerical checks, computer program controls, independent review report and reconciliations.
- An independent body should make periodic comparison of accounting records and the physical assets on hand.
- Any discrepancies thus obtained, when investigated, will uncover weakness either in procedures for safeguarding assets or in maintaining the related accounting records-recorded accountability.
- Periodic comparisons may include counts of cash on hand, reconciliation of bank statements, counts of securities, confirmation of accounts receivable and payables, and other such comparison of operations.
- The frequency of such comparison is governed by the related costs and benefits. Yet, periodic comparison and action to correct errors lowers the risk that material misstatements remain the account.

The accounting system

An accounting system consists of the methods and records established to gather and report an entity‘s transactions and to maintain accountability for the related assets and liabilities. An accounting system is maintained to attain the following objectives:

1. Identify and record all valid transactions
2. Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
3. Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
4. Determine the time period in which transactions occurred to permit recording of transaction in proper accounting period
5. Present properly the transactions and related disclosures in the financial statements.

Monitoring

After internal controls are put in place, their effectiveness needs to be periodically monitored to ensure that controls continue to be adequate and continue to function properly. Management must also monitor previously identified problems to ensure that they are corrected. COSO‘s updated internal control framework identifies two principles associated with monitoring: These are;

- Management should establish monitoring activities to monitor the internal control system and evaluate the results.
- Management should ensure identified internal control deficiencies are remediated on a timely basis.

An internal control system usually contains elements forming the basis for an effective system and contributes to accomplishing set objective of the institution. These elements can be separately identified as:

Sound management characteristics: the management style and characteristics of managers‘ display have a significant effect on the internal control environment. Managers should necessarily set an example as far as application and adherence to controls is concerned. If managers, on the different levels, continuously attempt to override or ignore these, then it can be expected that their subordinates do the same.

Efficient Organizational Structure: the organizational structure of the organization indicates the responsibility and authority of various officials as well as the lines of communication to be followed. If all officials clearly understood the structure and their responsibilities relative to other officials, this would certainly contribute to applying and maintaining the system.

Acceptable Personnel Policies: since competent and trustworthy personnel will produce reliable and accurate financial information and ensure internal controls are adhered to, it is important that personnel policies and practices form a critical part of internal control environments. As such, it is essential that policies be developed to the extent that personnel employed enhance compliance with controls and do not undermine the system.

Written Procedure: written procedures in the form of procedure manuals, instructions, and directives require developing for use by all staff. These written procedures are part of internal control, and therefore their practical application is vital in ensuring uniform approaches to tasks. This approach strengthens the system by setting minimum standards of conduct.

Effective Internal Audit Function: legislation requires the establishment of internal audit unit in each organization. One function of an internal audit unit is monitoring the effectiveness of the internal control system and reporting deficiencies to an audit committee and management. The auditors belonging to such a unit should be independent of the institution being monitored and should, therefore, report directly to the committee.

4.5. Limitation of Internal Control

Even if internal control can do much to protect against both errors and irregularities & assure the reliability of accounting data, it has inherent limitation. What so ever its structure is. Besides, the following situations increase the limitation of any internal control system.

Collusion: collusion can be defined as an agreement between two parties to defeat an internal control system to carry out an improper act. For instance, you may assign a store keeper and a guard to prevent assets from being taken for personal use, but what if these two persons collude.

Management outride or manipulation and collusion: management may override procedures designed to assure execution and recording of transaction in accordance with management authorization. For example, the manager may authorize improper payment to him and threaten employees under him to hide the theft.

Cost versus benefit: organization is faced with challenge to find the right cost-versus –benefit balance for internal control. Excessive control can be too costly and counterproductive, as result 100% control might not be adapted.

Temporary failure: there are two basic reasons under this limitation:

1. Human error: due to carelessness, interruption, fatigue (tiredness), misunderstanding institutions, etc.

2. Change: a new employer may hire and he/she makes mistake until they understand the system.

Mistake in judgment: this includes such as mistakes in recording transactions in wrong accounting period, erroneous classification of transactions, in capitalizing expenditure

4.6. The Auditor's Consideration of internal control

The position of the auditor regarding internal control has been stated in the statement of auditing practices issued by the Institute of Chartered Accountants of India which says "the duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguard and internal controls instituted by the management, although he/she will take into account the deficiencies, he/she may note therein while drafting his/her audit program". It clearly means that an auditor is concerned only with the evaluation of internal control to know its strength and weaknesses. In case he/she finds that the internal control system is inadequate, he/she should then plan to carry out detailed examination of those areas where the system is weak. It is therefore necessary for the auditor to acquaint himself fully with the internal control in force and their actual operation. It will help him in the formulation of his audit program. He/she may also bring the shortcomings of the internal control system to the notice of the management.

Study Note

- *The duty of auditor is concerned only with the evaluation of internal control to know its strength and weaknesses not safeguarding assets and documents.*

Activity

Question 3: *Discuss the consideration of auditor of internal control.*

_____

_____

_____

Chapter Summary

An organization‘s financial resources can be protected from loss, waste, or theft by developing an internal control system implementing it within its AIS. An internal control system ensures reliable data processing promotes operational efficiency. Internal control system aims to achieve four main objectives to safeguard assets, to check the accuracy and reliability of accounting data, to promote operational efficiency, and to encourage adherence to prescribed managerial policies. Internal Control is a process effected by an entity‘s board of directors, management, and other personnel providing reasonable assurance in effectiveness and efficiency, reliability of financial reporting, and compliance with applicable laws and regulations.

Glossary of Terms

Internal Control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working.

Internal Audit is described as the verification of the operations within the business by a specially assigned staff.

Risk is a probability or threat of damage, injury, liability, loss, or any other negative occurrence that is caused by external or internal vulnerabilities, and that may be avoided through preemptive action.

Authorization is the process of giving someone permission to do or have something.

Segregation of duties is the assignment of various steps in a process to different people.

Chapter Review Questions 4

Part I: Write ‘’TRUE’’ if the statement is correct and ‘’FALSE’’ otherwise.

1. The effectiveness of client‘s internal control system and the auditor‘s decision on the sample size (depth) of the audit has positive relationship.
2. External evidences are more reliable than internal evidences regardless of the effectiveness of the client‘s internal control system.
3. The internal control may be unique depending upon the nature and the size of the firm.
4. Collusion is an agreement between two parties to defeat an internal control system to carry out an improper act.
5. One department or individual can perform more than one of the functions of authorizing transactions, recording transactions, and maintaining custody over assets.

Part II: Choose the correct answer for the following multiple choice questions.

1. Identify ***incorrect*** statement.
   A. Physical access to assets and important records, documents, and blank forms should be limited to authorized personnel.
   B. Internal Control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working.
   C. Authorization is the process of giving someone permission to do or have something.
   D. All of the above
   E. None of the above
2. Identify the odd among the following lists.
   A. Internal auditing
   B. Management control method
   C. Management philosophy and operational style
   D. Organizational structure
   E. External auditing
3. The collective effects of all factors that establish, enhance, or mitigate the effectiveness of specific control policies and a procedure is;
   A. Control environment
   B. Control procedure
   C. Control activities
   D. Accounting control
   E. Monitoring
4. Which one is **false** about objectives of internal control structure of an organization?
   A. It safe-guards the assets and records of the organization
   B. It ensures the accuracy and reliability of the accounting data and information.
   C. It promotes inefficiency in all the organizations operations.
   D. It encourages adherence to managements prescribed policies and procedures.
   E. None of the above

5. In comparison to the external auditor, an internal auditor is not more likely to be concerned with;
   A. Internal administrative control.
   B. Cost accounting procedures
   C. Operational auditing.
   D. Internal control
   E. None of the above

Chapter 5: Audit Evidence

Dear Learners!

International standards audit (ISA) requires the auditor to obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. Audit evidence refers to information or data that use or collect by auditors as part their audit works to conclude their opinion on whether or not financial statements are prepared in all material respect and in accordance with the applicable financial frameworks. Before auditors could make the conclusion on the financial statements as a whole or any part, they need to make sure that the evidence they obtain is sufficient enough with appropriate quality to make the conclusion. Sufficient and appropriate audit evidence is important for the auditor to form audit opinions. Audit Risks that auditors might face also depend on audit sufficient and appropriate of the evidence. Audit evidence is obtaining by the auditor throughout all of the audit stages including the planning stage, execution stage, as well as conclusion stages. And to gather this evidence, the auditors use many different technologies and procedures suitable for them. In this chapter, we will discuss various topics related to the audit evidence including the relationship of evidence to audit risk, financial statement assertions, sufficient competent evidential matter, types of audit evidence and evidence about accounting estimates.

Objectives of the Chapter: After completing study on this chapter, student able to;

1. Discuss the relationship of evidence to audit risk,
2. Describe about financial statement assertions,
3. Identify features of sufficient competent evidential matter
4. Identify types of audit evidence
5. Understand evidence about accounting estimates.

5.1. The relationship of evidence to audit risk

The third standard of field work states _‘sufficient and competent evidential matter is to be obtained through inspection, observation, inquires and confirmation to afford reasonable basis for an opinion regarding the financial statement under audit.‘‘ Audit evidence also referred to as evidential matter refers to the necessary information that an auditor gathers in order to form a credible opinion on the assertions by the client‘s management that are inherent in the financial

statements. This evidence will therefore often include information relating to completeness, reliability and accuracy to the recorded value of assets, liabilities and equity of the client entity. The following are some examples of audit evidences.

- *In the client acceptance/retention stage*, audit evidence will include information that will enable the auditor to determine whether to accept or reject an entity as a client.
- *In the audit planning stage*, audit evidence includes information that will enable the auditor to determine the audit approach such as information relating to the likely effectiveness of particular internal control procedures.
- *In the control testing stage*, audit evidence includes information that will assist the auditor in determining whether or not internal controls are effective in their operation, such as information as to whether a particular control procedure is or is not supervised.
- *In the substantive testing stage*, audit evidence includes information as to whether a particular account balance is complete, valid and accurate, such as evidence that the asset actually exists.
- *In the opinion formulation stage*, audit evidence includes information relating to the completeness, validity and accuracy of financial statements as a whole, such as information relating to consistency of the financial statements with the auditor‘s knowledge of the business.

During the course of the audit, the auditor should obtain *sufficient, reliable, relevant and useful evidence* to achieve the audit objectives effectively. This helps the auditor support his/her findings and conclusions by appropriate analysis and interpretation of this evidence. A major decision facing every auditor is determining the appropriate types and amount of evidence to accumulate to be satisfied that the components of the client‘s financial statements and the overall statements are fairly stated. This judgment is important because of the prohibitive cost of examining and evaluating all available evidences. The auditor‘s decisions on evidence accumulation can be broken in to the following subdivisions. These are; which audit procedure to use? What sample size to select for a given procedure? Which items to select from the population? When to perform the procedures?

1. **Audit procedures:** audit procedure is the detailed instruction for the collection of a type of audit evidence that is to be obtained at some time during the audit.

2. **Sample size:** once an audit procedure is selected, it is possible to vary the sample size from one to all the items in the population being tested. The decision of how many items to test must be made by the auditor for each audit procedure. The sample size for any given procedure is likely to vary from audit to audit.
3. **Items to select:** after the sample size has been determined for an audit procedure, it is still necessary to decide which items in the population to test. If the auditor decides, for example, to select 200 checks from a population of 6,600 checks stubs for comparison with cash payments journal, several different methods can be used to select the specific checks to be examined like (a) a week and examine the first 200 checks, (b) select 200 checks from the largest amounts, (c) select the checks randomly, or (4) select those checks that the auditor thinks are most likely to be in error. Or a combination of these methods could be used.
4. **Timing:** an audit of financial statements usually covers a period such as a year, and an audit is usually not completed until several weeks or months after the end of the fiscal period. The timing of the audit procedures can therefore vary from early in the accounting period to long after it has ended. In the audit of financial statements the client normally wants the audit completed one to three months after the year end.

Study Note

- *During the course of the audit, the auditor should obtain sufficient, reliable, relevant and useful evidence to achieve the audit objectives effectively. This helps the auditor support his/her findings and conclusions by appropriate analysis and interpretation of this evidence.*

Activity

Question 1: *Discuss the relationship of evidence to audit risk.*

_____

_____

_____

5.2. Financial statement assertions

The conformity of a client‘s financial statements to GAAP is judged according to five different financial statement assertions: ***existence or occurrence, completeness, rights and obligations, valuation or allocation, presentation, and disclosure.***

Existence or Occurrence: existence relates to balance sheet accounts. Did the assets, liabilities, and equity which appear on the balance sheet, equally exist on the balance sheet date? **Occurrence** on the other hand, relates income statement accounts. Did the transactions giving rise to the revenue and expenses actually occur during the period covered by the income statement? Another way of expressing this assertion is to say ‗none of the accounts on the balance sheet or income statements are **overstated**.‘ If accounts are overstated it is called an error of commission. The existence or occurrence objective is most important with regard to assets and revenues. Overstating those two types of accounts makes the client‘s results look better. The client will have less benefit to overstate liabilities or expenses, except perhaps when presenting financial statements to the tax authorities.

Completeness: completeness related to both balance sheet and income statement accounts. Have all transactions for the year been recorded? Another way of expressing this assertion is to say ‗none of the accounts in the balance sheet or income statements are **understated**.‘ If accounts are understated, it is called an error of **omission**. The completeness objective is most important with regard to liabilities or expenses. Understating those two types of accounts makes the client‘s look better. The client will have less incentive to understate assets or revenues, except perhaps when presenting financial statements to the tax authorities.

Rights and Obligations: this assertion says that the client has legal rights to all its assets and legal obligations to all its liabilities. This assertion is especially important to assets physical existence on the client‘s premises does not necessarily mean ownership. For example, equipment may be leased to the business, or inventories may be consigned. Obligation may be of greater concern in a small business where the owner may list some of his/her personal liabilities as liabilities of the business.

Valuation or Allocation: valuation is more concern for balance sheet accounts. For example, have the fixed assets, receivables, and inventories correctly valued based on GAAP? Allocation has more to do with income statement accounts. Such as, have revenues and expenses been

allocated to the proper period according to the matching principle? Have factory overhead costs been allocated to products in inventory rather than charged as expenses?

Presentation and Disclosure: presentation has to do with classification of the accounts on the financial statements. For instance, are inventories for sale presented as current assets? Are bonds payable presented as long-term liabilities? Disclosure refers to the notes to the financial statements. Have significant accounting policies been explained? Have contingent liabilities been noted?

5.3. Sufficient competent evidential matter

The following are some of the requirements to be the audit evidence persuasive or convincing.

Sufficiency: sufficiency is the presence of enough factual and convincing evidence to support the auditor‘s findings, conclusions, and recommendations. Determining the sufficiency of evidence requires judgment; however, a prudent, informed person should be able to reach the same conclusions as the auditor. When appropriate, statistical methods may be used to establish efficiency. Though the sufficiency of audit evidence is determined by the auditor‘s professional judgment, the following factors are the determinants of sufficiency of audit evidences.

1. Competence of audit evidence determines the quantity of audit evidence required for a specific situation. That is, the more competent the audit evidence available the less the quantity of evidence is required to support evidence.
2. Materiality also affects the amount of audit evidence needed to support auditor‘s opinion. The more material the financial statements amount the greater the need for evidential matter as its validity.
3. The level of risk involved in audit engagement also determines the sufficiency of audit evidence. In every engagement there is a certain level of audit risk that auditors may overlook material misstatements which results in issuance of inappropriate opinion. Such risk varies from one engagement to the others depending on varies factors such as the client‘s financial condition, line of business and integrity of management. As the relative risk associated with a particular engagement increases the auditor should gather more evidences to support their opinion.

Competence: to be competent, evidence should be valid and reliable. In evaluating the competence of evidence, the auditors should carefully consider whether reasons exist to doubt its

validity and completeness. If so, the auditors should obtain additional evidence or disclose the situation in the audit report.

Quality: Competence of evidence also related to its quality. Evidence is said to be competent if it is both valid and relevant. There are a number of factors that affect the quality of evidence. The following are the major ones.

A. **The source of the audit evidence**: evidences obtained from independent sources outside the client are more reliable than evidences obtained from the client.

B. **The strength of the client's internal control*:*** the quality and reliability of audit evidence increases if the client has strong internal control.

C. **The ability of the auditor to gather firsthand information*:*** information obtained by auditors through personal observation, computation or using other techniques increases the reliability of evidences.

Relevance: Relevance refers to the relationship of evidence to its use that is, consistent with the audit objectives. The information used to prove or disprove an issue is relevant if it has a logical, sensible relationship to that issue. Information that is irrelevant should not be included as evidence to support audit findings and recommendation.

The reliability of audit evidence may be discussed by classifying documents as follows: evidence originated by the auditor, evidences created by third party, and evidences created by the management of the client.

I. Evidence originated by the auditor is particularity reliable since there is little risk of its manipulation by management. The auditor knows this because he/she has prepared it himself. Example include the following

- Analytical review procedures such as the calculation of ratios and trends in order to examine usual variations.
- Physical inspection or observation such as attendance of physical stock takes or inspection of a fixed asset
- Re-performance of calculation making up figure in the accounts such as the computation on the total inventory (stock) values.

II. Evidence obtained from third party independent of the client is more reliable than evidence produced by the client. Examples include:

- Confirmation letter obtained from client‘s customer and confirmation of bank balances.
- Reports produced by specialists, such as property valuations and legal opinions.
- Documents presented by the client which were issued by third parties such as invoices.

- Evidences originated from client management are less reliable than evidences obtained from outside party. The degree of reliance on such evidences depends on the reliability of the client internal control and the reliability of the item. Examples include: The client‘s accounting records and supporting schedules, the client‘s explanation (oral evidence) and information provided about the internal control system.

5.4. Types of audit evidence

When conducting audits, the auditors gather a combination of many types of evidence. Audit evidence is categorized as follows: **physical, documentary, testimonial, and analytical**.

1. **Physical evidence: -** physical evidence is obtained by direct inspection or observation (a) activities of people, (b) existence of property, or(c) events. Such evidence may be documented in the form of :

- Memoranda summarizing the matters inspected or observed
- Photographs
- Charts
- Maps, and
- Actual samples

The existence of property and equipment such as automobiles, buildings, office equipment, and factory machinery may be established by physical examination. Similarly, the amount of cash on hand is verified by counting, and inventory counts are observed. Physical examination or observation provides evidence as to the existence of certain assets, but generally needs to be supplemented by other types of evidence to determine the ownership proper valuation and condition of these assets.

2. **Documentary evidence:** the documents, forms, journals, or reports may originate within the client organization or may come from an internal source. Examples are:
   - Letters
   - Contracts
   - Charts
   - Regulations

- Budget information
- Accounting records
- Management information performance & other supporting documents.

In evaluating the reliability of documentary evidence, the auditor should consider whether the document is a type that could easily be forged or created in it‘s entirely by dishonest employee as the worth of document evidence depends in part upon its source. Documentary evidence is classified in to three categories depending on their source and reliability.

a. **Documentary evidence created outside the client organization and transmitted directly to the auditors:** this is the most reliable evidence and originates out the client and transmitted to the auditor without passing through the client‘s hands. In the verification of accounts receivable, for instance, the customer is requested by client to write directly to the auditors to confirm the amount owed to the client.
b. **Documentary evidence created outside the client organization and held by client:** these documents represent the significant portion of the documents used by auditors and is considered in general as a strong type of evidence than documents created by the client. Externally created documents and held by the client indicate bank statements, vendors‘ invoices and statements notes receivable, contracts notes receivables, contracts, customer‘s purchase orders, stock and bond certificates.
c. **Documentary evidence created and held within the client organization:** documents created within the client organization represent a-lower quality of evidence. Examples include sales invoices, shipping notices, purchase order, receiving reports and credit memoranda and paid check. The dependable single documentary evidence created within the client‘s organization is a paid check. The check bears the endorsement of the payee and a perforation or stamps indicating payment by the bank. Because of this review and processing of a check by outsiders, the auditors will usually upon a paid check as a strong type of evidence.

The degree of reliance to be placed on documents created and used only within the organization depends on the effectiveness of the internal control. Adequate internal control provides for extensive segregation of duties so that no one employee handles a transaction from beginning to end.

3. **Testimonial evidence (inquiry):-** testimonial evidence is obtained from others through statements received in response to inquiry or through interviews. Statements important to the audit should be corroborated when possible with additional evidence. Testimonial evidence also needs to be evaluated from the stand point of whether the individual may be biased or only have partial knowledge about the area.
4. **Evidence from analytical procedures:** analytical evidence is the result of analysis and verification. Analytical procedures involve evaluation of financial statements information by a study of relationships among financial and non-financial data. Example of analytical procedures include comparison of revenue and expense amounts for the current year to those of prior periods, to industry averages, to budgeted levels, and to relevant non-financial data. Such as units of produced, hours, or direct labor. Some of the techniques used to produce analytical evidence are comparisons; reasoning and separation of information into comparisons. In addition to the above mentioned types of evidence, auditors may obtain evidence from specialists such as geologists, engineers, attorneys, for performance of audit in areas that do require highly specialized knowledge.

Client representation letters (‗'rep-letter'') may also be considered as audit evidence. Representation letter is a letter written representation summarizing the most important oral discussions made during the audit engagement. Most of such representations fall in to following broad categories:

- ✓ All accounting records and financial data
- ✓ The financial statements are complete and prepared in conformity with GAAP
- ✓ All items requiring disclosure (such as loss contingencies, illegal acts, and related party transaction has properly disclosed).

5.5. Evidence about accounting estimates

Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Examples of accounting estimates include net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses. Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective

as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider with an attitude of professional skepticism, both the subjective and objective factors.

Chapter Summary

Audit evidence refers to information or data that use or collect by auditors as part their audit works to conclude their opinion on whether or not financial statements are prepared in all material respect and in accordance with the applicable financial frameworks. Before auditors could make the conclusion on the financial statements as a whole or any part, they need to make sure that the evidence they obtain is sufficient enough with appropriate quality to make the conclusion. Sufficient and appropriate audit evidence is important for the auditor to form audit opinions. Audit risks that auditors might face also depend on audit sufficient and appropriate of the evidence. Audit evidence is obtaining by the auditor throughout all of the audit stages including the planning stage, execution stage, as well as conclusion stages. And to gather this evidence, the auditors use many different technologies and procedures suitable for them. Auditors use audit evidence in many different forms and sources. Those audit evidence could be data or information, physical or nonphysical. In this chapter, we have discussed various topics related to the audit evidence including the types of evidence, the procedures that use by auditors to gather the evidence as well as the quality of it.

Glossary of Terms

Accounting estimate an approximation of a monetary amount in the absence of a precise means of measurement

Evidence any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria.

Competent information refers to the quality of the audit evidence

Sufficient information factual, adequate, and convincing information

Audit Assertions are the implicit or explicit claims and representations made by the management responsible for the preparation of financial statements regarding the appropriateness of the various elements of financial statements and disclosures.

Chapter Review Questions 5

Part I: Write ‘’TRUE’’ if the statement is correct and ‘’FALSE’’ otherwise.

1. Testimonial audit evidences are evidences that are obtained by the auditor through comparison of the client‘s different financial data.
2. Evidences originated from client management are less reliable than evidences obtained from outside party.
3. Sufficient and appropriate audit evidence is important for the auditor to form audit opinions.
4. The auditor is responsible for making and evaluating the reasonableness of accounting estimates made by management in the context of the financial statements.
5. Sufficiency is the presence of enough factual and convincing evidence to support the auditor‘s findings,

Part II: Choose the correct answer for the following multiple choice questions.

1. One is not among factors that affect the quality of audit evidence.
   A. The source of the audit evidence
   B. The strength of the client‘s internal control
   C. The ability of the auditor to gather firsthand information
   D. All of the above
   E. None of the above
2. The audit evidence to be persuasive or convincing should satisfy the following requirements except;
   A. Sufficiency
   B. Competence
   C. Quality

D. Relevance

E. None of the above

3. The implicit or explicit claims and representations made by the management responsible for the preparation of financial statements regarding the appropriateness of the various elements of financial statements and disclosures is;

   A. Assertions

   B. Sufficient information

   C. Competent information

   D. Evidence

   E. Accounting estimate

4. Identify false statement among the following

   A. Management is responsible for making the accounting estimates included in the financial statements.

   B. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements.

   C. A and B

   D. All of the above

   E. None of the above

5. Audit evidence is categorized as;

   A. Physical,

   B. Documentary,

   C. Testimonial,

   D. Analytical.

   E. All of the above

Chapter 6: Audit Reports

Dear Learners!

If all the facts concerning financial transactions were properly and accurately recorded and the owners and managers of business enterprises were entirely honest and sufficiently skilled in matters of accounting and recording, there would be little need for independent auditing. However, human nature being as it is, there probably will always be a need for the auditor. Many businesses, depending on size and nature, employ internal auditors. Their responsibilities and functions, while similar to those of an independent auditor, are vitally different in a major respect having to do with impartiality and independence. The reporting phase of an audit begins when the independent auditors have completed their field work and their proposed adjustments have been accepted and recorded by the client. Before writing their report, the auditors must review the client‘s financial statements on behalf of the client.

The financial statements on which the independent auditors customarily report are the balance sheet, the income statement, the statement of retained earnings, and the statement of cash flows. Often, the statement of retained earnings is combined with the Income Statement. In some cases, the retained earnings statement may be expanded to a statement of stockholders' equity. Financial statements generally are presented in comparative form for the current year and the preceding year and are accompanied by explanatory notes. The financial statements for a parent corporation usually are consolidated with those of the subsidiaries. This chapter discusses about the last step in the auditing process; audit reports.

Objectives of the Chapter: after completing study on this chapter, student be able to;

1. Define audit report.
2. Differentiate the different types of audit reports.
3. Describe contents of audit reports

6.1. Types of audit reports

The auditor's report is a formal opinion, or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or subdivision thereof (called an ―auditee‖). The report is

subsequently provided to a ―user‖ (such as an individual, a group of persons, a company, a government, or even the general public, among others) as an assurance service in order for the user to make decisions based on the results of the audit.

An auditor‘s report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor‘s reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor‘s report is ―essentially worthless‖ for investing purposes.

It is important to note that auditor's reports on financial statements are neither evaluations nor any other similar determination used to evaluate entities in order to make a decision. The report is only an opinion on whether the information presented is correct and free from material misstatements, whereas all other determinations are left for the user to decide. An audit opinion is expressed on audited statements. It is required that an auditor state in the opinion that generally accepted accounting principles have been followed that they have been applied on a basis consistent with that used the preceding year. Audit reports are required by law if a company is publicly traded or in an industry regulated by the Securities and Exchange Commission (SEC). Companies seeking funding, as well as those looking to improve internal controls, also find this information valuable.

There are **four** types of audit opinions namely; Unqualified, Qualified, Adverse, and Disclaimer.
Unqualified opinion: is used when the auditors find no departure from GAAP, or when he/she finds all evidence necessary to his/her satisfaction, and has been able to follow all GAAS. This opinion is issued if the financial statements reflect fairly the financial position of the firm for the stated period. It is used when there is no reason to qualify the report. This means:

- All necessary documents are included
- The three general standards of GAAS have been met
- The three field work standards of GAAS have been met
- The financial statements follow GAAP, and include any necessary disclosures

- There are no circumstance for which the report should be qualified

Qualified opinion: a qualified opinion states that the financial statements are presented in conformity with GAAP _‘ except‘‘ for the effect of some matters. Such type auditors‘ opinion is provided if the problem is **immaterial or insignificant and does not alter decisions** because of no effect in the overall accounting data. For example, if fixed assets estimated based on their current market value instead of their original cost, the effect would be only on the total assets and so it brings immaterial deviation.

Adverse opinion: is used when the auditor cannot apply all GAAS requirements and if GAAP have not been followed in preparing financial statements or if the financial statements are materially misstated. The possible causes of adverse opinion are:

- ✓ *Management restriction*: the management of the client may not allow the auditors to test some of the documents like marketable securities, receivables, some contracts, and so on.
- ✓ *Circumstances*: auditors may not able to collect sufficient and competent evidence due to the auditors‘ own problems like inappropriate atmosphere, lack of infrastructures in some working areas, and due to some outdated data to test the validity of financial statements.

In such case auditors are expected to state‘‘ in their opinion‘‘ that the financial statements do not represent the financial position of the firm plus they are expected to explain the reasons for stating so.

Disclaimer opinion: means no opinion and such type of opinion is issued when there is no sufficient information to conclude as to whether the financial statements present fairly the financial position of the organization. The possible reasons may *be management restrictions and/or lack of independence of auditors with the client*.

Materiality and audit opinion: Materiality refers to the significance or important of information which is provided by the auditors to the users of the audit report and it also related with the effectiveness of the auditors procedures (sufficiency, completeness, appropriateness, & relevancy of the audit procedures). Materiality is an essential consideration in determining the appropriate type of report for a given set of circumstances. Materiality is important in the issuance of audit report because materiality is one of the basis whether an audit procedure has to be done with the certain item/s in the financial statements, therefore, items in the financial

statements which are below the set up materiality, would not be considered in the examinations and no way can be included in the audit report.

There is an direct relationship between materiality and audit report, higher the materiality of an items the higher would be the audit risk which directly impact on the auditor‘s report, keeping in view the materiality of an items the auditor has to show plan his /her audit so that the audit risk kept an acceptable low level which will support the auditor to give a reasonable assurance on the audit report.

6.2. Contents of audit reports

Regardless of the auditor, the following are the seven parts of the standardized audit report.

1. **Report title:** auditing standards require that the report be titled and that the title include the word ***independen***t. For example, appropriate titles would be _‘independent auditor‘s report,‘‘ _‘report of independent auditor,‘‘ or _‘independent accountant‘s opinion.‘‘ The requirement that the title include the word _‘independent‘‘ is intended to convey to users that the audit was unbiased in all aspects of the auditor.
2. **Audit report address:** the report is usually addressed to the company, its stockholders, or the board of directors. In recent years, it has become customary to address the report to the stockholders, to indicate that the auditor is independent of the company and the board of directors.
3. **Introductory paragraph:** the first paragraph of report has three things:

- It makes the simple statement that the audit firm has done an audit. This is intended to distinguish the report from a compilation or review report.
- It lists the financial statements that were audited, including the balance sheet dates and the accounting periods for the income statement and statement of cash flows. The wording of the financial statements in the report should be identical to those used by the management on the financial statements.
- The introductory paragraph states that the responsibility of management and that the auditor‘s responsibility is to express an opinion on the statements based on an audit. The purpose of these statements is to communicate that management is responsible for selecting the appropriate generally accepted accounting principles and making the measurement

decisions and disclosures in applying those principles, and to clarify the respective roles management and the auditor.

4. **Scope paragraph:** the scope paragraph is a factual statement about what the auditor did in the audit. This paragraph first states that the auditor followed generally accepted auditing standards. The remainder briefly describes important aspects of an audit.

It also states that the audit is designed to obtain reasonable assurance about whether the statements are free of material misstatement. The inclusion of the word _‘material‘‘ conveys that auditors are responsible only to search for significant misstatements, not minor errors that do not affect users‘ decisions. The use of the term _‘reasonable assurance‘‘ is intended to indicate that an audit cannot be expected to eliminate completely the possibility that a material error or irregularities will exist in the financial statements. In other words, an audit provides a high level of assurance, but it is not guarantee. The remainder of the scope paragraph discusses the audit evidence accumulated and states that the auditor believes the evidence accumulated was appropriate for the circumstances to express the opinion presented. The words _‘test basis‘‘ indicate that sampling was used rather than an audit of every transaction and amount on the statements.

5. **Opinion paragraph:** the final paragraph in the standardized report states the auditor‘s conclusion based on the results of the audit examination. This part of the report is so important that frequently the entire audit report is referred to simply as the *auditor's opinion*. The opinion paragraph is stated as an opinion rather than as a statement of absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. The phrase _‘in our opinion‘‘ indicates that there may be some information risk associated with the financial statements, even though the statements have been audited. The opinion paragraph is directly related to the first and fourth generally accepted auditing report standards. The auditor is required to state an opinion about the financial statements taken as a whole, including a conclusion about whether the company followed generally accepted accounting principles.

One of the controversial parts of the auditor‘s report is the meaning of the term *present fairly*. Does this mean that if generally accepted accounting principles are followed, the financial statements are presented fairly, or something more? Occasionally, the courts have conclude that

auditors are responsible for looking beyond generally accepted accounting principles to determine whether users might be misled, even if those principles are followed. Most auditors believe that financial statements are _‘presented fairly‘‘ when the statements are in accordance with generally accepted accounting principles, but that is also necessary to examine the substance of transactions and balances for possible misinformation.

6. **Name of the audit firm:** the name identifies the audit firm or practitioner that has performed the audit. Typically, the firm‘s name is used, since the entire audit firm has the legal and professional responsibility to make certain the quality of the audit meets professional standards.
7. **Audit report date:** the appropriate date for the report is the one on which the auditor has completed the most important auditing procedures in the field. This date is important to users because it indicates the last date of the auditor‘s responsibility for the review of significant events that occurred after the date of the financial statements. For example, if the balance sheet is dated December 31, 1991, and the audit report is dated March 5,20x5, this indicates that the auditor has searched for material unrecorded transactions and events that occurred up to March 5,20x5.

Contents of short form of Auditors’ Report

The Introductory Paragraph: the introductory paragraph emphasizes on the types of F/S that was under audit and clearly distinguish the responsibility of the client and the auditor. The client company is primarily responsible for the financial statements and that auditors are expected to render a report on the financial statements.

The Scope Paragraph: the scope paragraph describes the nature of the audit, which it was conducted in accordance with generally accepted auditing standards and provides **reasonable assurance** that the financial statements are free of material misstatement.

The Opinion Paragraph: in the opinion paragraph, the auditors are expressing nothing more than an informed opinion. They do not guarantee or certify that the statements are accurate.

Independent Auditors' Report:

To the Board of Directors and Stockholders of ABC Company:

We have audited the accompanying balance sheet of ABC Company as of December 31, 2001, and the related statements of income, retained earnings, and cash flow for the year then ended.

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 2001, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Callahan, Durant, Simms & Co.
Westminster, Maryland
Certified Public Accountants
March 1, 2002

Chapter Summary

The Auditor's report is a formal opinion by either an internal auditor or an independent external auditor as a result of an internal or external audit performed on a legal entity or subdivision thereof (called an ―auditee‖). The report is provided to a ―user‖ (such as an organization or a government) as an assurance service in order for the user to make decisions based on the results of the audit. This is considered an essential tool when reporting financial data; many users require financial information to be certified by a certified public accountant and/ or the state auditor, and this has become best market practice. This auditor's report advises users on whether the auditee's financial statements have been prepared in accordance with a stated set of accounting principles (GAAP), whether they are free of material misstatement (e.g. free of important and significant errors), and whether they show a true and fair view of the operating results, financial position and cash flows of the auditee. The report is thus an assurance on

whether the financial information presented by the auditee is materially trustworthy for making various decisions. There are four different types of auditor opinion issued, which are considered standard and mandatory in accordance with Generally Accepted Auditing Standards (GAAS). GAAS provide guidance on the objectives and general principle governing an audit of financial statements. Various GAAS frameworks exist, comprising a set of systematic guidelines used by auditors when conducting audits, ensuring the accuracy, consistency and verifiability of auditors' actions and reports. The principal frameworks recognized worldwide include the US GAAS and International Standards on Auditing (―ISA‖). The auditing standards applied should be specified in the auditor‘s opinion.

Glossary of Terms

Auditor opinion is a formal statement made by an auditor concerning a client‘s financial statements.

Audit report is a formal opinion by either an internal auditor or an independent external auditor as a result of an internal or external audit performed on a legal entity or subdivision thereof (called an ―auditee‖).

Unqualified Opinion issued when the organization‘s financial condition, position, and operations are fairly presented in the accounts.

Qualified Opinion report states that the financial statements are fairly presented with a certain exception which is otherwise misstated.

Adverse Opinion is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not conform to GAAP.

Disclaimer Opinion is issued when the auditor could not form, and consequently refuses to present, an opinion on the financial statements.

Chapter Review Questions 6

Part I: Choose the correct answer for the following multiple choice questions.

1. A type audit opinion issued when the auditor has been *unable to satisfy himself/ herself* that the overall financial statements are fairly presented.
   A. Disclaimer of opinion
   B. Qualified opinion

C. unqualified opinion
D. Adverse opinion
E. None of the above

2. Which of the following best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?
   A. It is difficult to prepare financial statements that fairly present a company‘s financial position, operations, and cash flows without the expertise of an independent auditor.
   B. It is management‘s responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.
   C. The opinion of an independent party is needed because a company may not be objective with respect to its own financial statements.
   D. It is a customary courtesy that all stockholders of a company receive an independent report on management‘s stewardship of the affairs of the business.
   E. None of the above
3. The CPA firm has done an audit, lists the financial statements that were audited, states that the statements are the responsibility of management and that the auditor‘s responsibility is to express an opinion on the statements based on an audit is expressed in;
   A. Introductory paragraph
   B. Scope paragraph
   C. Opinion Paragraph
   D. Conclusions paragraph
   E. None of the above
4. Information/evidence relating to the completeness, validity and accuracy of financial statements as a whole and such as information relating to consistency of the financial statements with the auditor‘s knowledge of the business is collected at the;
   A. Client acceptance
   B. Audit planning stage
   C. Control testing stage
   D. Substantive testing stage
   E. Opinion formulation stage
5. Which one of the following statement is correct?

A. There is an indirect relationship between materiality and audit report
B. Materiality is an essential consideration in determining the appropriate type of report for a given set of circumstances.
C. Disclaimer opinion means there is an opinion
D. Adverse opinion is used when the auditor can apply all GAAS requirements.
E. None of the above

Part II: Case Question

Table below shows long **form audit report**. The names of each contents of the report in the right column of the table are represented by Letters from A to G.

ANDERSON and ZINDER, P.C. Certified Public Accountants Suite 100 Park Plaza East Denver, Colorado 80110, 303/359-0800	
Independent Auditor‘s Report	***A***
To the Stockholders General Ring Corporation	***B***
We have audited the accompanying balance sheets of General Ring Corporation as of December 31, 2011 and 2010, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company‘s management. Our responsibility is to express an opinion on these financial statements based on our audits.	***C***
We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.	***D***
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Ring Corporation as of December 31, 2011 and 2010, and the	***E***

results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.	
ANDERSON AND ZINDER, P.C., CPAs	***F***
February 15, 2012	***G***

Required:

I. Write the name of the content or paragraph denoted by each letters.

II. The type of audit opinion expressed in the above report is_____

Chapter 7: Auditing and Auditors in Ethiopia

Dear Learners!

In previous chapters you have studied about the fundamental concepts, principles and practices of auditing in general. Particularly, the previous part of this module covered an overview of auditing, the auditing profession, planning and conducting the audit, internal control and its relation to audit, audit evidence and audit reports. In this chapter, you will study about auditing and auditors in Ethiopia. More specifically, you will learn about historical development of auditing in Ethiopia, types of audit and auditors in Ethiopia.

Objectives of the Chapter: After completing study on this chapter, students be able to

1. Discuss the historical development of auditing in Ethiopia
2. Identify the different types of audit in Ethiopia
3. Differentiate private/external auditing in Ethiopia, performance audit and compliance audit.
4. Identify the different types of Auditors in Ethiopia

7.1. Historical Development of Auditing in Ethiopia

The process of auditing professionalization in Ethiopia appears to exhibit distinct patterns during the three epochs when the state followed capitalist-oriented (pre 1974), Communist (1974 through to 1991), and then capitalist-oriented (1991 onwards) ideologies. Auditors in Ethiopia are classified in to external (independent) auditors which are performed by certified and authorized private auditors, internal auditors and government auditors. The Commercial Code of Ethiopia contains articles that are related to the auditing practice in Ethiopia. There are also different types of auditing in Ethiopia. These includes: Private (External) auditing, internal auditing, performance auditing, and compliance auditing, investigation auditing, project and contract auditing.

Pre 1974: In Ethiopian context, auditing is relatively new phenomenon in earlier periods, the responsibility to administer and control the country‘s revenue and expenditure was exclusively performed by ministry of finance. Government auditing in Ethiopia dates back to the establishment of an Audit Commission by proclamation No. 69/1944 during Emperor Regime. Major power and function of the Commissions were as follows:

- Responsible for the examination and control of the accounts of the Ministry of Finance, and was directly accountable to the Prime Minister
- The power to control and examine the accounts of all other Ministries was given to the Officers of the Ministry of Finance.

The Establishment of Audit and Control Office

In 1946, proclamation No. 79/1946 was provided to centralize the audit control of all government accounts in one department by establishing the Audit and Control office under the direction of the comptroller and Auditor General who reported and was directly responsible to the prime Minister. As a result of this proclamation, the powers and duties of the new office were clearly defined and the scope of its activities expanded. According to the Revised Constitution of 1955 (1948 E.C.) provided even wider duties and a large measure of independence. Accordingly, the Auditor General reported to the Emperor and the Parliament on the financial operations of the government and was given access to all books and records of government accounts. Functions of Auditors General Subsequently, the functions of the auditor general were amended by decree No.32 of1958 which was later renumbered as proclamation No.179/1961(1958E.c). The major power and Functions of Auditor General were as follows:

- Auditing the accounts of all autonomous bodies existing by virtue of Imperial charters
- Conducting the audit of the chartered organizations, established to provide essential services to the public, through its charted organizations.

The Commercial Code of Ethiopia: the Commercial Code of Ethiopia, enacted in 1960 contains articles that are related to the auditing practice in Ethiopia. The Commercial Code of Ethiopia contains provisions requiring partnership and corporation (Share Company) to keep books and accounts, related to corporations specifically about appointment of auditors, competency of auditors, professional secrecy and liabilities of auditors. Furthermore, the code specifies persons who are founders and beneficiaries of a company or its subsidiary, persons related by blood to the fourth degree, or persons who receive remuneration from company founders cannot appointed as auditor. It also states that directors are not to engage in auditing that company (Principle of Independence). In addition, according to the code, an auditor is liable for breach of professional secrecy, for negligence in the performance of professional services, and for breach of contract. According to the Commercial Code, auditors are liable to client and

third party for losses they cause, for issuing inappropriate report, for failure to inform the law for any offences that they knew was committed by the client that affects the public.

1974 – 1991: Following a revolution in Ethiopia, a military government came into power in Ethiopia in1974 and declared a communist ideology. As a result, private companies underwent nationalization and the number of state-owned companies in the country increased. Following this, international public accounting firms that have been operating in Ethiopia were closed. However, beside the nationalization event an important landmark in the history of accounting and auditing in this period was the formation of the Audit Service Corporation (ASC) by Proclamation 126/1977 (Government of Ethiopia, 1977).

Functions of Audit Service Corporations (ASC): the ASC mainly had performed external audit of public enterprises. ASC had render audit services to production, distribution and service giving organizations of which the Government is the owner or majority shareholder.

Study Note

- *The process of auditing professionalization in Ethiopia appears to exhibit distinct patterns during the three epochs when the state followed capitalist-oriented (pre 1974), Communist (1974 through to 1991), and then capitalist-oriented (1991 onwards) ideologies.*
- *Auditors in Ethiopia are classified in to external (independent) auditors which are performed by certified and authorized private auditors, internal auditors and government auditors.*

Activity

Question 7.1: *Discuss about the historical development of audition in Ethiopia.*

_____

_____

_____

7.2. Types of Audit in Ethiopia

There are three types of auditing in Ethiopia. These are Private/External auditing in Ethiopia, Performance Audit and Compliance Audit

Private/External auditing in Ethiopia

Private auditing practice was started with the opening of a branch office of Price Waterhouse Peat & Co. in Addis Ababa, following the establishment and growth of multinational British companies like A. Bessie & Co., Mitchell Cotts Ltd., and Shell; and the issuance of the commercial Code of Ethiopia in 1960. The demand for commercial audit has increased, as the Commercial Code of Ethiopia required the multinational companies to present audited financial statements for renewal of trade license. The Office of Auditor General audits or causes to be audited the accounts of the Federal Government offices and organizations. On the other hand, the Audit Service Corporation provides auditing services to public enterprises.

The private businesses also need audited financial statements for various purposes such as for bank loan and for tax purposes. Thus, private auditing firms provide auditing, accounting services, tax services, and management advisory services on fee basis primarily to the private businesses. The type of audit conducted by private auditing firms is financial statement audit.

You can open a private auditing firm and provide auditing services to the public if you meet the requirements of the Office of Auditor General. The Office of Auditor General issues license to private auditors.

Performance Audit

In Ethiopia, performance audit is mostly done in governmental organizations by both internal and external private auditors. However some private organizations and nongovernmental organizations also employ external and internal auditors and undertakes performance audit. In Ethiopia it is the least developed type of audit. In Ethiopia there is no law which enforces privately owned organizations to undertake performance audit.

Compliance Audit

Compliance Audit in Ethiopia mostly focuses on tax audit done by tax auditors of Ethiopian government. A tax audit is a systematic examination of business`s relevant commercial system to

determine whether a taxpayer‘s declaration states the tax liability correctly and complying with the provisions of the tax laws and related subsidiary legislations. Auditing involves examination of financial statements, books of accounts and vouchers of a taxpayer by Tax Auditors so as to ascertain whether the taxpayer has accurately considered revenues and expenses when determining the taxes shown in the declarations as per the requirements of the tax laws. It also involves other approaches such as observation of premises, direct monitoring of receipts in cash businesses, use of mark-up techniques and analysis of key ratios. The overall objective is to improve the compliance of taxpayers, whether they declare the correct amount of tax and paid at the right time. The expectation by a taxpayer of an audit should have a deterrent effect and encourage the taxpayer to declare as far as possible a credible tax return. It also improves the taxpayer‘s understanding and awareness of the relevant taxes.

Activity

Question 7.2: *Identify and describe about the different types of audits in Ethiopia.*

_____

_____

_____

7.3. Types of Auditors in Ethiopia

Internal Auditors

The history of the development of internal auditing in Ethiopia dates back to about the middle of the 1940s just about the time when internal audit was evolving as an organized profession in the United States. Internal audit in Ethiopia, had its early legislative root in the Constitution of 1923 which authorized the establishment of an ―Audit Commission‖ (Articles 34); and the Audit Commission itself was established much later by Proclamation 69/1944 to audit the accounts of the Ministry of Finance. The same Proclamation mandated the then Ministry of Finance to audit other budgetary institutions as a measure of internal control over the financial operations of the budgetary institutions. It appears that this early practice of internal auditing as per Proclamation. 69/1944 was, in fact, to be the root of what the Inspection Department of the Ministry of Finance and Economic Development (MoFED) continued to perform to this day, until the recent

reorganization. The latter part of the 1940s witnessed the establishment of internal audit functions in key public sector institutions such as the national defense, education, road construction, and other non-budgetary public sectors, which included the Ethiopian Airlines, Telecommunication and the financial sector consisting of the modern layer of the Ethiopian economy. These institutions in one way or the other had external links or financing operations, which created awareness of the need for internal controls to sectarian appropriate financial management and to safeguard organizational assets.

The period of the early 1950s, marked the introduction of a budgetary system in government. The commencement of an annual public budget in 1955 for the first time in the history of the country ushered in a system of financial administration based on the annual budget with all its attendant requirements for strengthened internal control in the budgetary agencies. This entailed the formation of internal audit as an integral part of the budgetary internal control system. The establishment at the time of the Addis Ababa Commercial School and the Addis Ababa University College supplied with limited but better informed manpower, for some key institutions in the economy.

Governmental Auditors

Government auditors are employed by various local, state, and federal governmental agencies. At the federal level, the three primary agencies are the Office of Auditor General, the audit service corporation, and the federal Inland Revenue authority. The office of Auditor General is a federal organization headed by the auditor general. This office is responsible for conducting financial statement audit, compliance audit and operational audit of various Federal Government offices. The regional governments have also their own regional audit bureau with similar functions. The Federal Inland Revenue Authority (Recently renamed as Ministry of Revenue) is responsible for administering the federal tax laws. Thus, the authority‘s auditors audit the returns of taxpayers for compliance with applicable tax laws. That is, the auditors examine the tax returns of the taxpayer to ensure that it is prepared in accordance with the tax laws and regulations. The authority‘s auditors are known as tax auditors. Another government organ that performs audit is the audit Service Corporation. The Audit services corporation audits the financial statements of the public enterprises. Thus, the type of audit performed by the audit

service corporation is financial statement audit. Governmental Units that provides auditing service in Ethiopia includes;

Independent (External) Auditor

An independent auditor, also known as certified public accountant or external auditor, has no connection to the organization being audited. Independent auditor conducts the audit on a fee basis, and is primary responsible to third parties-creditors and shareholders. The type of audit carried out by an independent auditor is financial statement audit. In Ethiopia, the authorized auditors perform financial statement audit. In addition, the Audit service corporation a government—owned organization, performs financial statement audit.

Study Note

Types of Auditors in Ethiopia are Internal Auditors, Governmental Auditors and Independent (External) Auditor

Activity

Question 7.1: *Identify and elaborate about the different types of auditors in Ethiopia.*

_____

_____

_____

Chapter Summary

The process of auditing professionalization in Ethiopia appears to exhibit distinct Patterns during the three epochs when the state followed capitalist-oriented (pre 1974), Communist (1974 through to 1991), and then capitalist-oriented (1991 onwards) ideologies. Auditors in Ethiopia are classified in to external (Independent) auditors which are performed by certified and authorized private auditors, internal auditors and government auditors. The Commercial Code of Ethiopia contains articles that are related to the auditing practice in Ethiopia. There are also different types of auditing in Ethiopia. These includes: Private (External) auditing, internal auditing, performance auditing, and compliance auditing. The Office of Auditor General as a

responsible organ for auditing in Ethiopia pays key role including a development, management and administration of auditing in Ethiopia.

In Ethiopia audits seem to be done primary on account of government regulation. For example, NGO are audited because the assets of the NGOS are deemed a ―national asset,‖ the use of which is ultimately accountable to the government of Ethiopia. Auditing in Ethiopia could be viewed in five main areas of audit sectors.

The office of the auditor general (OAG): The powers and functions of the office of the OAG are given through the proclamations that established it, its sphere of activity lies in government audit.

The audit service corporation: duty and functions of this entity involve mostly commercial audits of commercial and productive enterprises wholly or partially owned by government.

Ministry of finance audit and inspection: Auditing activity in this area includes audit of ministries and government departments by MF auditors and inspectors, including tax audit by Inland Revenue authorities.

Corporations' and enterprises' auditors: These are audits performed by internal auditors within enterprise.

Private audit firms: engaged in fee based auditing services

Glossary of Terms

An audit of financial statements is to determine whether the financial statements have been prepared in conformity with generally accepted accounting principles.

An operational audit is study of some specific unit of an organization for the purpose of measuring its performance. The operation of a unit can be evaluated for its effectiveness and efficiency.

Compliance audits determine whether the specified rules, regulations, or procedures are being carried out or followed.

Independent (external auditors): Independent auditors have no connection to the firm as an owner or employee/manager. The basic task of independent auditor is to confirm to the owners that the employees are correctly reporting on their financial position and performance.

Internal auditor: An internal auditor is paid salary as employee on the organization that is being audits. He/she is responsible to appraise and investigation the performance of unit and/or units within the organization and give recommendation to top management.

Government audit: The government auditor is paid a salary by the government. He/she is responsible to the legislature or executive.

Chapter Review Questions 7

Part I: Write ''TRUE'' if the statement is correct and ''FALSE'' otherwise.

1. An audit of financial statements in Ethiopia is to determine whether the financial statements have been prepared in conformity with generally accepted accounting principles.
2. In Ethiopia, compliance audit is concerned the examination of some specific unit of an organization for the purpose of measuring its performance.
3. In Ethiopia, audits seem to be done primary on account of government regulation.
4. In Ethiopia, performance audits determine whether the specified rules, regulations, or procedures are being carried out or followed.
5. The Office of Auditor General is responsible for conducting financial statement audit, compliance audit and operational audit of various Federal Government offices.

Part II: Choose the correct answer for the following multiple choice questions.

1. A type of auditor has no connection to the firm as an owner or employee/manager with the task to confirm to the owners that the employees are correctly reporting on their financial position and performance is;
   A. Independent Auditor
   B. Government audit
   C. Internal auditor
   D. All of the above
   E. None of the above
2. Duty and functions of auditing of commercial and development enterprises in Ethiopia wholly or partially owned by government is;
   A. The office of the auditor general

B. The audit service corporation
C. Ministry of finance audit and inspection
D. Corporations‘ and enterprises‘ auditors
E. Private audit firms

3. Audit Service Corporation was found during;
   A. Before 1974
   B. During 1923 to 1955
   C. During 1974 to 1991
   D. In 1991
   E. In 1994
4. Auditors in Ethiopia are classified as;
   A. External (independent) auditors
   B. Private auditors,
   C. Internal auditors
   D. Government auditors
   E. All of the above
5. The contents of Commercial Code of Ethiopia about auditing contains;
   A. Competency of auditors, professional secrecy and liabilities of auditors
   B. persons who are founders and beneficiaries of a company or its subsidiary cannot be appointed as auditor
   C. States that directors are not to engage in auditing that company
   D. All of the above
   E. None of the above

Answer Key

Answer for Chapter Review Questions 1:

Part I: True/False Questions

1. **True**
2. **True**
3. **False**
4. **True**
5. **False**

Part II: Multiple Choice Questions

1. **B**
2. **B**
3. **B**
4. **C**
5. **C**

Answer for Chapter Review Questions 2:

Part I: True/False Questions

1. **True**
2. **False**
3. **False**
4. **True**
5. **True**

Part II: Multiple Choice Questions

1. **E**
2. **A**
3. **D**
4. **A**
5. **E**

Answer for Chapter Review Questions 3:

Part I: True/False Questions

1. **True**
2. **True**
3. **False**
4. **True**
5. **True**

Part II: Multiple Choice Questions

1. **E**
2. **E**
3. **A**
4. **D**
5. **D**

Answer for Chapter Review Questions 4:

Part I: True/False Questions

1. **True**
2. **True**
3. **True**
4. **True**
5. **False**

Part II: Multiple Choice Questions

1. **D**
2. **E**
3. **A**
4. **C**
5. **D**

Answer for Chapter Review Questions 5:

Part I: True/False Questions

1. **False**

2. **False**
3. **True**
4. **False**
5. **True**

Part II: Multiple Choice Questions

1. **D**
2. **E**
3. **A**
4. **E**
5. **E**

Answer for Chapter Review Questions 6:

Part I: Multiple Choice Questions

1. **C**
2. **B**
3. **A**
4. **D**
5. **A**

Part II: Part II: Case Question

I. Contents of the audit reports

A=Report title

B=Audit report address

C=Introductory paragraph

D=Scope paragraph

E=Opinion paragraph

F=Name of the audit firm

G=Audit report date

II. The type of audit opinion expressed is **unqualified opinion**

Answer for Chapter Review Questions 7:

Part I: True/False Questions

1. **True**
2. **False**
3. **True**
4. **False**
5. **True**

Part II: Multiple Choice Questions

1. **A**
2. B
3. C
4. E
5. D

References

1. Arens, J. Elder & S. Beasley, Auditing & Assurance services; an integrated Approach, 14th edition Prentice Hall.
2. Commercial Code of Ethiopia, 1960
3. Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Controls Integrated Framework (2013)
4. David N. Ricchinte, Auditing concepts and standards, south-western publishing House
5. Kassahun, G. (2010) General Concept of Auditing in Ethiopia, https://Independent.Academia.Edu/Kasahungilo.
6. O. Ray Whittngton & Kurt Pany, principles of auditing, 11th edition, the McGraw-Hill Publishing Company.
7. Yohannes Kinfu, (. (1990). Accounting And Auditing In Ethiopia: An Historical Perspective, Paper Presented to The First National Conference of Ethiopian Studies, Addis Ababa.