UNIT 2: THE AUDITING PROFESSION

2.0 AIMS AND OBJECTIVES

When you have studied this unit you should be able to:

- understand independence in fact and in appearance.
- understand the AICPA code of professional ethics.
- define the major legal concepts that relate to auditors' liability.
- describe the auditor's responsibility for the detection of fraud and error.

2.1 Introduction

This unit covers 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.

This unit also covers the duties and legal liabilities of auditors.

Broadly defined, the term **ethics** represents the moral principles or rules of conduct recognized by an individual or group of individuals. Ethics apply when an individual has to make a decision from various alternatives regarding moral principles.

2.2 INDEPENDENCE

The AICPA code of professional conduct requires a member in public practice to be independent in the performance of professional services as required by standards promulgated by bodies designated by council.

The requirement is stated in terms of "standards promulgated by bodies designated by council" to conveniently permit inclusion or exclusion of independence requirements for certain types of services provided by CPA

firms. For example, independence is required for audits of annual financial statement but a CPA firm can do tax return and provide management services without being independent. Independence in auditing means an unbiased viewpoint in the performance of audit test, the evaluation of results, and the issuance of the audit report.

Independence has two distinct aspects. First, the public accountants must **in fact** be independent toward any enterprise they audit. Second, the relationships of public accountants with audit clients must be such that they will **appear** independent to third parties.

Independences in fact refers to the auditor's ability to maintain unbiased and impartial mental attitude or state of mind in all aspects of work. As such independence in fact is not subject to objective measurement and therefore can be judged only by the auditor.

Independence in appearance refers to the auditor's freedom from conflict of interest, which third parties may infer from circumstantial evidence.

The following paragraphs illustrate some of the common situations, which may impair independence.

- **Investment interest in audit client: -** An auditor's investment in shares, bonds, mortgage, and notes of an audit client or its associates, either direct or indirect, may impair independence. In this situation, an auditor may be in a position to issue an opinion or to influence the client's financial statements for personal financial gains at the expense of his/her capacity as auditor. Such an investment is not limited to the auditor but also applies to his or her immediately family and to partners and their immediate families.

- **Non audit functions and services: -** Certain functions are incompatible with the auditing function. These include functioning as a

director, officers or employee of an audit client. The auditor's involvement in these functions and services creates a conflict of interest.

- **Litigation between CPA firm and client:** When there is a lawsuit or intent to start a lawsuit between a CPA firm and its client, the ability of the CPA firm and client to remain objective is questionable.
- **Hospitality or goods and services: -** This will affect independence unless it is modest.
- **Undue dependence on income: -** If the amount of income from a client is very large as compared to the total annual income of the audit firm, independence will be impaired since the auditors want to maintain this financial interest.

2.3 PROFESSIONAL QUALIFICATION REQUIREMENTS

A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date development in practice, legislation and techniques.

Auditing standards require auditors to have adequate educational requirement as well as other moral and legal criteria fulfillment. The educational requirements are composed of theoretical knowledge and practical experience.

2.4 PROFESSIONAL ETHICS

All recognized professions have developed codes of professional ethics. Professional ethics refer to the basic principles of right action for the member of a profession. Professional ethics may be regarded as a mixture of moral and practical concepts. Thus the professional ethics of an

accountant would signify his behavior towards his fellows in the profession and other professions and towards members of the public.

The fundamental purpose of such codes is to provide members with guidelines for maintaining a professional attitude and conducting themselves in a manner that will enhance the professional stature of their discipline.

The AICPA code of professional conduct considers the following to be followed by auditors (accountants) in the conduct of professional relations with others.

- **Integrity: -** An accountant should be straightforward, honest and sincere in his approach to his professional work.
- **Objectivity: -** An accountant should be fair and should not allow bias to override his objectivity. When reporting on financial statements, which come his review, he should maintain an impartial attitude.
- **Independence: -** When in public practice, an accountant should **both be and appear to be** free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.
- **Confidentiality**: - A professional accountant should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
- **Technical standards: -** An accountant should carry out his professional work in accordance with the technical and professional standards relevant to that work.
- **Professional competence: -** An accountant has a duty to maintain his level of competence throughout his professional career. He should only undertake works, which he or his firm can expect to complete with professional competence.

- **Ethical behavior: -** An accountant should conduct himself with a good reputation of the profession and refrain from any conduct, which might bring discredit to the profession.
- **Contingent fess: -** The AICPA code of professional conduct prohibits a CPA firm from rendering any professional services on a contingent fee basis.
- **Responsibilities to colleagues: -** The auditor should promote cooperation and good relations with other members of the profession.
- **Advertising: -**_The advertising should not be false or misleading," should not contravene "professional good taste," should not make "unfavorable reflection on the competence or integrity of the profession," and should not" involve a statement the contents of which" cannot be substantiated.

2.5 LEGAL RESPONSIBILITY AND LIABILITY OF AUDITORS

The auditor is responsible for his report. The auditor then has certain duties to fulfill to the users of the financial statements that he reports on.

Responsibilities impose liabilities if things go wrong.

Liable for what?

The CPA can be sued under the following legal concepts.

(i) **Prudent man concept: -** The auditor is responsible for exercising due professional care, and he is subject to lawsuit if he fails to do so.

(ii) **Liable for acts of others: -** The partners are jointly liable for civil actions against a partner.

(iii) **Lack of privileged communication: -** CPA^{S} do not have the right under common law to withhold information from the courts on the grounds that the information is privileged.

Definition of Terms

Negligence: is violation of legal duty to exercise a degree of care that an ordinary prudent person would exercise under similar circumstances with resultant damages to another party.

Gross negligence: is lack of event slight care. Many jurisdictions consider gross negligence equivalent to constructive fraud.

Fraud: is defined a misrepresentation by a person of a material fact, known by that person to be untrue.

Constructive fraud: differs from fraud as defined above in that constructive fraud does not involve a misrepresentation with the intent to deceive.

Privity: is the relationship between parties to a contract.

Breach of contact: is failure of one or both parties to a contract to perform in accordance with the contract's provisions.

Proximate cause: exists when damage to another is directly attributable to a wrongdoer's act.

Contributory negligence: is negligence on the part of the client that has contributed to his or her having incurred a loss.

A. Auditors' liability to their clients

When CPA^{S} take on any type of engagement, they are obliged to render due professional care. This obligation exists whether or not it is specifically set forth in the written contract with the client. Thus, CPA^{S} are liable to their clients for any losses proximately caused by the CPA'^{S} failure to exercise due professional care. That is to recover its losses, an injured client need only prove that the auditors were guilty of negligence and that the auditors' negligence was the proximate cause of the client's losses.

B. Auditors' liability to third parties

Bankers and other creditors or investors who utilize financial statements covered by an audit report can recover damages from the auditors if it can be shown that the auditors were guilty of fraud or gross negligence in the performance of their professional duties.

Moreover, the auditors can be held liable for negligence to a limited class of third parties if the auditors have actual knowledge of such third parties or if there exists a special relationship between the auditors and the third parties.

The clients (plaintiffs) must prove that they sustained losses, that they relied on the audited financial statements, which were misleading, that this reliance was the primate cause of their losses, and that the auditors were negligent.

C. Auditors' responsibility for the detection of fraud and error

The detection and prevention of error and fraud is the management's responsibility by designing and implementing appropriate internal control systems. The auditor is not responsible for the prevention and detection of error and fraud. The auditor is responsible to design audit procedures to reduce the risk of not detecting a material error or fraud, to an appropriate level to provide reasonable assurance. Accordingly, the auditor must

exercise due care in planning, performing, and evaluating the results of audit procedures.