CHAPTER ONE

1. THE NATURE, PURPOSE AND SCOPE OF AUDITING

Definition of Auditing

There are different definitions of auditing forwarded by different authors. The following, by serves our purpose more.

"[Auditing is] the independent examination of financial statements of any entity, whether profit oriented or not, and irrespective of its size and legal form, when such an examination is conducted with a view to expressing an opinion thereon." International Federation of Accountants (IFAC)

The following are also cited as essential features of auditing:

- To make a critical review of the accounting and internal control systems
- To make such tests and enquiries as considered necessary to form an opinion as to the reliability of the records as a basis for the preparation of accounts
- To compare the financial statements with underlying records in order to see whether they are in accordance there with
- To make a critical review of the financial statements so as to report whether, the opinion of the auditors, they show a true and fair view of the state of affairs of the auditee.

The following comprehensive definition is given by Gupta and Arora:

"*Auditing is a process of collection and evaluation of evidence for the purpose of reporting on economic information*"

Three key phrases from the above definition are noted and elaborated as follows:

Economic information

The term includes:

- Financial statements like balance sheet, profit and loss account, costing statements, tax returns, internal management reports, stock records and the like.

Reporting

- The auditor examines the information under audit and expresses his opinion on the same by way of a written report.
- The audit report is the end product of the audit process.

Collection and Evaluation of Evidence

The auditors' report stated above is formed by collecting and evaluating evidence.

The auditor collects information employing techniques like:

- Physical examination
- Examination of documents
- Obtaining certificates, confirmations and statements, etc.

According to Arens and Loebbecke, "*auditing is the process by which a competent, independent person accumulates and evaluates evidence about quantifiable information related to a specific economic entity for the purpose of determining and reporting on the degree of correspondence between the quantifiable information and established criteria."*

This definition is also comprehensive like the one seen above but stresses competence and independence of the auditor as well as significance of established criteria or set of rules, regulations and guidelines governing activities of the economic entity under audit, against which actual performance is checked.

Distinction between Accounting and Auditing

Many users confuse auditing with accounting. The confusion is caused as:

- Most auditing is concerned with accounting information
- Many auditors have considerable expertise in accounting
- Individuals primarily responsible for the audit function are titled 'Certified Public Accountants'

Proper descriptions of the two functions follow:

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

To provide relevant information, accountants must have thorough understanding of principles and rules of preparing the information and develop a system that ensures proper and timely recording of economic events of the entity at a reasonable cost.

Auditing is concerned with determining whether recorded information properly reflects the economic events occurred during the accounting period.

- The auditor involved with the accounting information must thoroughly understand the accounting rules viz. generally accepted accounting principles, against which the accounting records are evaluated.
- The auditor must also possess expertise in the accumulation and interpretation of audit evidence.

Types of Audit and Auditors

Types of Audits

Three types of audit are considered in this section

- Operational audits
- Compliance audits
- Audit of financial statements

Operational Audits

An operational audit is a review of any part of an organization's operating procedures and methods for the purpose of evaluating efficiency and effectiveness. Recommendations for improvement are normally expected upon completion of the audit.

- It is difficult to characterize the conduct of a typical operational audit as different areas of operation can be evaluated.

- The reviews are not limited to accounting but can also include evaluation of organizational structure, computer operations, production methods, marketing and the like.
- Efficiency and effectiveness of operations are difficult to evaluate objectively and establishing criteria for evaluating quantifiable information in an operational audit is an extremely subjective matter.
- Thus, operational auditors are usually more concerned with making recommendations for improving performance than with reporting on the effectiveness of existing performance.
- Operational auditing, in this sense, is more similar to management consulting than to what is generally regarded as auditing.

Compliance Audits

The purpose of compliance audit is to determine whether the auditee is following specific procedures or rules set down by some higher authority.

There are prescribed policies, contractual agreements, and legal requirements that call for compliance auditing in virtually every organization.

For a private business a compliance audit may include:

- Reviewing minimum wage rate for compliance with minimum wage law
- Examining various contractual agreements to ensure whether the company is complying with relevant legal requirements

There is increased compliance auditing in government units due to extensive regulations by higher government authorities.

Results of compliance audits are generally reported to someone within the organizational unit being audited. Management, as opposed to outside users, is the primary group concerned with the extent of

compliance. Hence, a significant portion of this type of work is done by auditors employed by the organizations themselves.

An organization may also employ auditors to determine whether other organizations or individuals are complying to its requirements when it has such authority. A good example of this is the Tax Authority which employs its own auditors to ensure that taxpayers are complying with the tax law.

Audits of Financial Statements

An audit of financial statement is conducted to determine whether the overall financial statements are stated in accordance with specified criteria. Normally, the criteria are generally accepted accounting principles. The financial statements most commonly included are:

- The statement of financial position
- Income statement
- Statement of changes in financial position including accompanying footnotes

The assumption underlying an audit of financial statements is that they will be used for different purposes by different users and the conclusion drawn by one auditor after performance of audit is relied upon by all users for efficiency reasons. There are of course some users who do not rely on the general purpose statements and conduct further investigations depending upon their specific needs.

Types of Auditors

The most common types of auditors are:

- Auditors of the Office of the Federal Auditor General (OFAG)
- Tax auditors
- Internal auditors
- External auditors

Auditors of the Office of the Federal Auditor General (OFAG)

The office of the Federal Auditor General of the Federal Democratic Republic of Ethiopia is established by Proclamation No. 68/1997. The

Federal Auditor General is appointed by the Council of Peoples Representatives upon recommendation by the Prime Minister. The Federal Auditor General is accountable to the Council of Peoples' Representatives and between sessions to the President of the Federal Republic.

Some of its major powers and duties are the following:

- Audit or cause to be audited the accounts of the Federal Government offices and organizations
- Audit or cause to be audited accounts involving budgetary subsidies and any special grants extended by the Federal Government to Regional Governments
- Audit the accounts of private contractors relating to the Federal Government contractual work which involves a sum exceeding Br. 500,000
- Carry out or cause to be carried out, as may be necessary, program and efficiency or performance audit in order to ensure that the performance of Federal Government offices and organizations is in accordance with the law, economically sound and has attained the desired objectives
- Report audit findings to the head of the audited Federal Government office or organization, the result of the audits performed shall also be immediately submitted to the Council of Peoples' Representatives, where it indicates the commission of a crime
- Issue directives, in cooperation with other offices concerned, regarding accounts and property auditing procedures and standards
- Issue certificates of competence to internal auditors to be employed by any Federal Government offices and organizations
- Where it has reasons to believe that any account has been kept in a criminal and dishonest manner, impound such books,

documents, ledgers, vouchers and other materials related to such account

- Make efforts, in cooperation with other concerned government offices, with a view to promote the Accounting and Auditing Profession; take appropriate measures to ensure that the development of the Accounting and Auditing Profession of the Federal Government is in the right direction
- Issue, renew, suspend and cancel certificates of competence of private auditors and accountants.

The OFAG, thus, hires its own auditors to discharge the above stated duties and responsibilities. The auditors of OFAG are expected to have extensive knowledge of relevant Federal Government rules and regulations, accounting policies and procedures as well as Generally Accepted Accounting Principles (GAAP), and audit procedures of OFAG.

The accounts of the Office of the Federal Auditor General shall be audited by a body to be designated by the Council of Peoples' Representatives or by the President of the Federal Republic.

Each Regional Government also has an office entrusted with the powers and duties of auditing various organs of the Regional Government, among other things.

Tax Auditors

The Federal Inland Revenue Authority and similar offices of the Regional Governments are entrusted with responsibility of enforcing the tax laws. To this end, the tax authorities engage their own auditors to audit tax returns of taxpayers to determine whether such tax returns comply with the tax law. The tax returns audited have varying degrees of complexity.

Those auditors who are engaged in audit of financial statements to this effect by the tax authority are expected to have considerable knowledge in the areas of Generally Accepted Accounting Principles (GAAP), taxation or provisions of the tax law, and auditing.

Internal Auditors

Internal auditors are employed by individual companies to audit for management and provide valuable information for making decisions concerning effective operation of the business. The size and responsibility of the internal audit group varies considerably depending upon the size and requirement of the organization, and the internal audit reports to:

- The president or the CEO directly
- Another high executive officer
- Or the audit committee of the board of directors

Some internal audit staffs consist of one or two employees and engage in routine compliance auditing only; others may consist of numerous employees who have diverse responsibilities, including many outside the accounting area. Many internal auditors have become involved in operational auditing or have developed expertise in evaluating computer systems.

To operate effectively, the internal auditor must be independent of the line functions in an organization, but he/she cannot be independent of entity as long as the employer-employee relationship exists.

Independent External Auditors

The primary responsibility of the external auditors is the performance of audit function on published financial statements. Most of the discussions to be made hereafter shall refer to performance of this function.

In Ethiopia the OFAG is the licensing authority as stated above and membership of an internationally recognized professional body like CPA and post qualification audit experience of up to three years is required to be licensed to practice as an independent auditor.

Purpose of Audit

The purpose of an external audit engagement is to enable the auditor express an opinion on whether the financial statements audited:

- Give a true and fair view or present fairly in all material respects the entity's affairs
- Are prepared, in all material respects, in accordance with an applicable financial reporting frame work

This opinion is embodied in the audit report and addressed to those interested parties who commissioned the audit or to whom the auditor is responsible under relevant statue.

In expressing the audit opinion the auditor has to carry out such procedures and take such steps as designed to obtain reasonable assurance that the financial are properly stated in all material respects. There are certain inherent limitations present in any kind of examination which require the use of judgment. Hence there is an unavoidable risk that even some material misstatements may remain undiscovered, and absolute certainty in auditing is rarely attainable.

However, it is the sacred duty of the auditor to plan and perform the audit with an attitude of professional skepticism that the financial statements being audited may be materially misstated and extend his procedures even at the slightest indication of fraud or error which may result in material misstatements so that he can confirm or dispel his suspicions.

Thus the opinion expressed by the auditor helps to establish the extent of credibility of the financial statements but should not be construed as an assurance as to the future viability of the organization or as to the efficiency or effectiveness with which the management has conducted the affairs of that unit.

Agency Theory

Agency relationships occur when one party, the principal, employs another party, the agent, to perform a task on their behalf. Modern

organization theory views an organization as comprising various interest groups often called stakeholders.

The stakeholders a company are all those who are influenced by, or can influence, the company's decisions and actions and ranges from the shareholders to management and the community in the local neighborhood.

Those stakeholders charged with governance i.e. those whose role is to supervise management need to ensure that the management operate the business in the interests of the shareholders and other stakeholders and not, purely in their own, personal interests.

In most countries it is possible for businesses to operate through companies - a process known as incorporation which has two implications:

- The creation of a distinction between the owners of the business and the business itself, which may in turn lead to the business being run by managers who are distinct from its owners
- The granting of limited liability status so that, if the business fails, the owners only stand to lose a specific amount of money – hence the term limited.

A legal framework was therefore needed for how companies should be operated

- To protect business owners from unscrupulous managers
- To protect the business world and the public at large from owners taking unfair advantage of limited liability status

This in turn had two results

- The legal requirement for accounts to be prepared by management on a regular basis to account to the shareholders for their stewardship of the business
- The recognition of the need for those accounts to be checked in some way by someone independent of the managers – the auditor.

Stewardship is the responsibility to take good care of resources. A steward is a person entrusted with management of another person's property.

There is a fiduciary or good faith relationship between shareholders and managers of a company. There is a separation of ownership and control in the sense that the shareholders own the company while the directors take the decision at the company. The directors must take their decisions in the interests of the shareholders rather than in their own selfish personal interests.

In terms of agency theory, directors can be seen as the agents of the shareholders, employees as the agents of directors and external auditors as agents of shareholders.

Each principal needs to recognize that, although he is employing the agent, the agent will have interests of his own to protect and thus may not fully carry out the requirements of the principal – a conflict of interest may arise. An example of this could be:

The directors have a duty of stewardship of the company's assets. However, they are also interested in their level of remuneration and, if this increases, the assets of the company go down. The decision to award directors pay increase may be in the hands of the directors themselves.

Scope of an Audit

The scope of an audit is dependent upon:

- The terms of agreement between the auditor and the client
- Statutory requirements
- Requirements of relevant professional bodies

A properly conducted audit is organized to cover adequately all aspects of the organization as far as they are relevant to the financial statements under audit. To this end the auditor:

- Studies and evaluates the accounting systems and the related internal controls and tests the internal controls to decide on the nature, extent and timing of other audit procedures
- Carries out such other tests, enquiries and other verification procedures of transactions and balances as considered appropriate

The auditor then bases his opinion by:

- Comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize transactions and events
- Considering the judgments the management has made in preparing the financial statements
- Assessing the selection and consistent application of accounting policies and the manner in which information has been classified, and the adequacy of disclosure

It should be noted that the auditor is not responsible for the preparation of the financial statements on which opinion is formed and expressed. This is the responsibility of the management of the particular organization and also covers:

- Maintenance of adequate accounting records and internal controls
- The selection and application of appropriate accounting policies and
- Safeguarding of the assets of the organization

The managers are not entitled to rely upon the auditor to protect them from any short comings in carrying out their responsibilities whereas the auditor is entitled to rely upon safeguards and internal controls instituted by the management.

Of course informing and expressing professional opinion on the financial statements the auditor has his own independent responsibility. This responsibility is heavy and cannot be discharged

without a full realization of the professional skill and judgment which need to be exercised in carrying out his duties.