

UNIT 2: The Auditing Profession

2.1. Introductions

A profession is an organized group of people who possess a unique skill, which benefits society.

Any recognized profession has characteristics to be shared with other professions. The most important of these characteristics are:

- Responsibility to serve the public: Acceptance of social responsibility
- Complex body of knowledge
- Standard of qualification for admission
- Need for public confidence/level of status recognition
- Standard conduct of behavior

The AICPA sets professional requirements for CPAs, conducts research, and publishes materials on many different subjects related to accounting, auditing, attestation and assurance services, management consulting services, and taxes.

The AICPA is empowered to set standards (guidelines) and rules that all members and other practicing CPAs must follow.

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). International Standards on Auditing [ISAs] are issued by the International Auditing Practices committee [IAPC]. The IAPC is a standing committee of the Council of the International Federation of Accountants [IFAC], which was formed in 1977 and is based in New York. IFAC has more than 140 member bodies, representing over 2 million accountants in 103 countries and membership of IFAC automatically

2.2. Auditing principles and standards

Auditing Principles

Principles are generally, guideines that help direct or chart goals and aims. Auditing principles are broad guidelines that help identifying auditing goals and objectives or help direct efforts towards goals. Principles are based on concepts or assumptions, and/or developed from particular observations and conventions/customs. Whichever way they are developoed they are necessary for evaluating alternative methods of doing things, for realizing differing perceptions, harmonizing views and practices, and help uniformity. Auditing professions in many countries have attempted to embody these guidelines in their professional association emblems. For example in US and UK “truth, fairness and objecivity” were identified as basic auditing principles, other have tried to base their accounting principles on accounting principles them selves. In Ethiopia for example the Ethiopian Professional Association of Accountants and Auditors [EPAAA] had the following as principle guidelines in its emblem, “Retee Laele Kulu”.

Auditing Standards

Standards are criterion or measure of quality of performance. They serve as roads against which work performed is compared and thus principles are translated into more practical adhereable terms. In thisregard it would seem that standards are more specific than principles, though there are authors in accounting that consider principles and standards to be the same or interchangeable.

Generally Accepted Auditing Standards- United States

There are 10 generally accepted auditing standards which are broadly classified as:

General Standards

1. Adequate training and proficiency
 - ✓ The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.

3. Due professional care

- ✓ The auditor must exercise his /her profession in the performance of the audit and the preparation of the report.

Standards of Field Work

1. Proper planning and supervision

- ✓ The auditor must adequately plan the work and must properly supervise any assistants.

2. Understanding of the entity

- ✓ The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement and to design further audit procedures.

3. Sufficient appropriate evidence

- ✓ The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. Statements prepared in accordance with GAAP

- ✓ The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. Circumstances when GAAP not followed

- ✓ 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.

3. Adequacy of disclosures

- ✓ Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. Expression of opinion on financial statements

- ✓ The report shall contain an expression of opinion regarding the financial statements, taken as a whole.

NB. The term generally accepted auditing standards is no longer used for public company audits it is used for audits of private companies. Zern

2.3 Rules of professional conduct/Professional Ethics

The purpose of having rules of professional conduct in any profession is to build public confidence, to judge the quality of work and means of grounding guidance of conduct for practitioners. Rules of professional conduct will be developed a particular professional body where by all member will be governed with it. The advantages of prescribing professional rules of conduct is to promote positive activity and encourage high level of performance while preventing mal-practices. However, there is difficulty in concretising them because:

- They are prescribed in general terms to avoid prescribing unacceptable behaviour.
- It is difficult to interpret behaviour without reference to specific situation at which point it requires interpretation of rulings according to circumstances.

Ethics can be defined broadly as a set of moral principles or values.

The word “ethics” in general usage means the philosophy of human conduct with emphasis on “right” and “wrong” which are moral questions.

“Right action” for a professional will of course include conformity with moral standards, but will also include behavior designed for practical as well as idealistic purposes.

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 Need For Professional Ethics

Four basic needs to be met:

- ✓ **Credibility:** In the whole of society there is a need for credibility in information and information system. It is essential that the information be considered to be thoroughly accurate, reliable and viewed as impartial.
- ✓ **Professionalism:** There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.
- ✓ **Quality of services:** There is a need for assurance that all services obtained from professional accountant are carried out to the highest standards of performance.
- ✓ **Confidence:** Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics, which governs the provision of those services.

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.

Accountants have a responsibility to:- Avoid conflicts of interest, Refrain from activity that would prejudice their ability to carry out their duties ethically, Refuse gifts, favors, or hospitality that would influence their actions, Refrain from subverting attainment of the organization's legitimate and ethical objectives.

- **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. In line with this, Contingent fee: The AICPA code of professional conduct prohibits a CPA firm from rendering any professional services on a contingent fee basis.

Accountants have a responsibility to: - Communicate information fairly and objectively, disclose fully all relevant information that could reasonably be expected to influence user's understanding of the reports, comments, and recommendations presented.

- 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.

Accountants have a responsibility to:- Refrain from disclosing confidential information, Inform subordinates as to how to handle confidential information, Refrain from using confidential information for unethical or illegal advantage.

- 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.

Accountants have a responsibility to:- Maintain professional competence, Perform professional duties in accordance with relevant laws, regulations, and technical standards, Prepare complete and clear reports and recommendations.

2.4. 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: - CPAs 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

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.

Ordinary 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 even slight care. Many jurisdictions consider gross negligence equivalent to constructive fraud.

Contributory negligence: is negligence on the part of the client that has contributed to his or her having incurred a loss. A common example is failure to provide the auditor with required information.

Privity: is the relationship between parties to a contract.

Breach of contract: 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.

Third-party beneficiary: a third party who does not have privity of contract, but is known to the contracting parties and is intended to have certain rights and benefits under the contract.

Plaintiff: is the party claiming damages and bringing suit against the *defendant*.

Engagement Letter: is the written contract summarizing the contractual relationships between auditor and client. The engagement letter typically specifies the scope of professional services to be rendered, expected completion dates and the basis for determination of the audit fee.

Liabilities of the auditor

The following are legal liabilities of the auditor.

- Liability to clients
- Liability to third parties
- Criminal liability

Liability to clients

When CPAs 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, CPAs are liable to their clients for any losses proximately caused by the CPAs' 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. Particularly:-

- The most common source of liability arising from failure of performing auditing functions with due care
- The cases often involve defalcations that the auditor has failed to uncover
- The principal issue normally concerns the level of care required
- Failure to meet generally accepted auditing standards is often conclusive evidence of negligence
- The defense used by the auditor are one of:
 - o Non-negligent performance
 - o Contributory negligence: When the client is informed in writing of weaknesses in control
 - o Lack of duty to perform
 - o Absence of causal connection

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 prime cause of their losses, and that the auditors were negligent.

- A professional would be liable, just as any other person would be, for actually defraud a third party

- The concept of fraud is stretched by some courts the concept of fraud beyond to include any known misrepresentation on a financial statement even if there were no direct intent to defraud

Preferable defense mechanism is: Non-negligent performance

Criminal liability

- It is a criminal offense to defraud another person through knowingly being involved with false financial statements
- Few criminal actions involving auditors
- The potential for criminal charges has both negative and positive effects on the profession
- Negative effect on:
 - The profession's ability to attract and retain outstanding people
- Positive effect
 - May encourage practitioners to use extreme care to act in good faith in all their activities.

Rights of the auditor

The rights given to the auditor under national legislation are designed to ensure that he is able to fulfill his duties and responsibilities to the members. These rights are fundamental to his independence. In countries with a well-developed auditing profession, auditors generally have unrestricted rights of access to books and records of a company, subject only perhaps, to considerations of national security. In those countries where there is no tradition of reporting in true and fair terms, it often comes as a surprise to directors and employees to find auditors asking for documents that previously, only the tax auditors had a right to see. The list of rights set out below reflects the position in countries in which the profession is mature.

Legal rights:

- The rights of access to books, records, documents and accounts of the company

- The right to require, from the officers of the company, such information and explanations as he thinks necessary for the performance of his duties.
- The rights to:
 - o Receive all notices relating to any general meetings of the company
 - o Attend any general meetings, and
 - o Be heard at any general meeting on any part of the business, which concerns him as auditor.
- The right to be sent by the company a copy of a notice of intention to propose his removal or replacement and the right to make written or oral representations
- The right to require the directors to requisition a general meeting on his resignation and to attend and be heard at that and any other meeting that concerns him.