Individual Assignment

- **List**, **explain** and **criticize** in detail about rules governing audits or legal and professional requirements of the
  - appointment, Remuneration
  - removal
  - Resignation
  - eligibility
  - registration
  - Training of auditors
  - Regulation, monitoring and supervision
  - Ethics
  - Legal liability
  - rights and duties of auditors.
- In Ethiopian scenario via citing the name, article and page numbers of the documents.
- ***NB: Copying work of others is punishable!!***

Advanced Auditing and Assurance

An overview of Auditing

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Brainstorming questions

- What is auditing?
- Why auditing? (need and reasons)
- When auditing?
- How auditing?
- Who should be an auditor?
- Auditing and accounting?
- Do an audit added values?

Learning Objective 1

Describe auditing.

Nature of Auditing

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, independent person.

Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards *(criteria)* by which the auditor can evaluate the information.

Accumulating and Evaluating Evidence

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

Evidence takes many different forms, including:

- *Electronic and documentary data about transactions*
- *Written and electronic communication with outsiders*
- *Observations by the auditor*
- *Oral testimony of the auditee (client)*

•Reasonable level of assurance
•Limited level of assurance

Competent, Independent Person

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate to reach the proper conclusion after the evidence has been examined.

*Auditors strive to maintain a high level of **independence** to keep the **confidence** of users relying on their reports.*

The competence of the individual performing the audit is of *little value* if he or she is biased in the accumulation and evaluation of evidence.

Auditors are paid fees by the company on which being audited. ***So how an auditor can become independent???***

Audit Report

The final stage in the auditing process is preparing the *Audit Report*, which is the communication of the auditor's findings to users.

Audit reports must inform readers of the ***degree of correspondence*** *between the information audited and established criteria.*

True and fair presentation. This is generally taken to mean that financial statements:
- Are factual
- Are free from bias
- Reflect the commercial substance of the business's transactions

Elements of an assurance engagement

- One way to remember these five elements of an assurance engagement is using the mnemonic CREST.
- Criteria: standards
- Report
- Evidence
  - Sufficient and appropriate evidence needs to be gathered
- Subject matter: data to be evaluated
  - historical financial information
  - nonfinancial performance (eg key performance indicators),
  - processes (eg internal control) and
  - compliance with laws and regulations
- Three party relationship
  - The intended user
  - the responsible party (Management) and
  - the practitioner (auditor)

Reasons for auditing

- As society becomes more complex, decision makers are more likely to receive unreliable information.
- There are several reasons for this:
- Remoteness of Information: information is obtained from others, the likelihood of it being intentionally or unintentionally misstated increases.
- Biases and Motives of the Provider: the information may be biased in favor of the provider, for example, the borrower will bias the statements to increase the chance of obtaining a loan, like incorrect dollar amounts or inadequate or incomplete disclosures of information.
- Voluminous Data: As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that *improperly recorded* information is included in the records—perhaps buried in a large amount of other information.
- Complex Exchange Transactions: exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly.

Why Auditing?

There are various people interested in the financial statements of a company. They are called **stakeholders**.

Particularly in larger companies, the **owners of a company and the management of that company are distinct.**

Directors are **accountable** to the shareholders in their role as **stewards** and **agents.** Accountable means being required to justify actions and decisions.

Why auditing?

- To reduce information risk
  - improve the *quality of the information* in the accounts and
- To build public confidence and trust

When auditing?

- Statutory and non-statutory audits
- *Statutory audits* are required under national rules and regulations
- *Non-statutory audits* the company's owners, or other interested parties want them, rather than because the law requires them.

Distinguish Between: Auditing and Accounting

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

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

*In addition to understanding accounting, the auditor must possess expertise in the **accumulation and interpretation** of audit evidence.*

Assurance Services

- An ***assurance service*** is an independent professional service that improves the quality of information for decision makers.
- 'Assurance' here means the auditors' satisfaction as to the reliability of the assertion made by one party for use by another party.
- Assurance services can be done by CPAs or by a variety of other professionals.
- An ***attestation service*** is a type of assurance service in which the CPA firm issues a report about the reliability of an *assertion* that is made by another party.
- Attestation services fall into five categories:
- 1. *Audit of historical financial statements:* In an audit of historical financial statements, management asserts that the statements are fairly stated in accordance with applicable international accounting standards.

- 2. *Audit of internal control over financial reporting*: The auditor attest to the effectiveness of internal control over financial reporting.
- 3. *Review of historical financial statements :* The CPA provides a *lower level of assurance* for reviews of financial statements compared to a high level for audits, therefore less evidence is needed.
- 4. *Attestation services on information technology:* management makes various assertions about the reliability and security of electronic information.
- 5. *Other attestation services :* CPAs provide numerous other attestation services , many of these services are natural extensions of the audit of historical financial statements.
- *NB:* In each case, the organization being audited must provide an assertion before the CPA can provide the attestation.

Non-assurance Services Provided by CPAs

- CPA firms perform numerous other services that generally fall outside the scope of assurance services. Three specific examples are:
- 1. Accounting and bookkeeping services
- 2. Tax services
- 3. Management consulting services

TYPES OF AUDITS

- 1. **Internal Audit:** evaluates the effectiveness of a company's internal controls and its corporate governance and accounting processes.
- **2. External Audit:** is a type of *assurance engagement* that is carried out by an auditor to give an independent opinion on a set of financial statements. It may be either
- **1. Operational audit:**
- **2. Compliance audit**
- **3. Financial statement audit or**
- **4. Forensic audit**

Internal vs. External Auditing

#	Internal Audit	External Audit
1	Internal auditors are appointed and removed by the management of the company any time.	External auditors are appointed and removed by the shareholders directly during AGM.
2	The scope of I/A is much broader and covers all risks to a business entity.	The scope of E/A is specified in the terms of reference signed with the company.
3	The objective of I/A is to help management in risk management and add value by creating efficiency in systems and finally obtain the objectives of a business entity.	The objective of E/A is to report on the truth and fairness of the financial statements by examining underlying records and based on the evaluation of evidence gathered during the work.
4	Internal auditors report to the audit committee.	External auditors report to the shareholders' representatives, the members on the board of directors. They directly interact with members while sitting in AGM or EGM.
5	The report of internal auditors is shared with management via audit committee.	The report of external auditors is shared with the shareholders and after being published is shared with public, in the case of listed company having share capital from public.

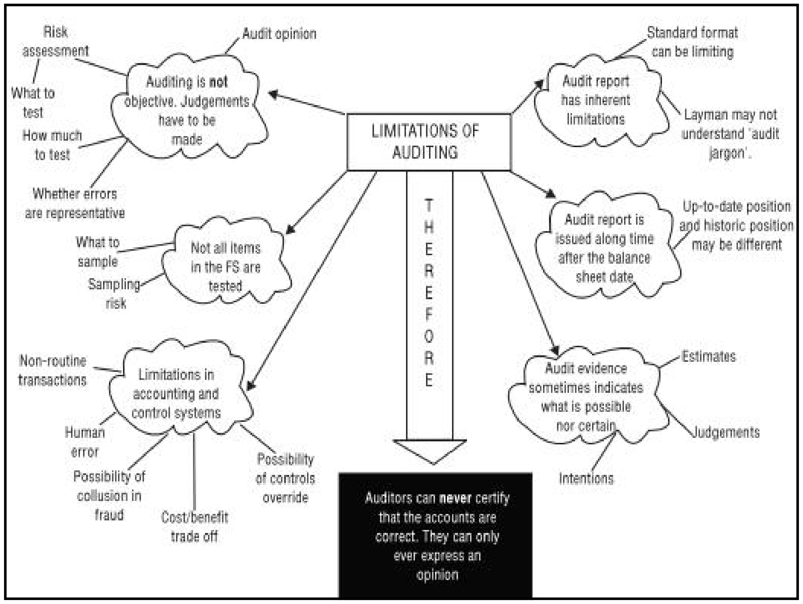
Internal Audit	External Audit
Independent of the activities audited (not of the organization)	1. Total independent of the audited organization and its activities
Considers the effectiveness and efficiency of the management system	2. Only considers the effectiveness of the management system
Advisory role within the organization for continual improvement	3. No advisory role within the organization (only general recommendations)

TYPES OF AUDITORS

- 1. **External Auditor:**
- **2. Internal Auditor:**
- **3. Tax Auditor**
- **4. Governmental general office auditor**

Audit Process (How)

- To provide such assurance, the auditors must:
- • Assess risk
- • Plan audit procedures
- • Conduct audit procedures
- • Assess results
- • Express an opinion



Generally Accepted Auditing Standards (GAAS)

General Standards	Standards of Field Work	Reporting Standards
1. The auditor must have adequate technical training and proficiency.	1. Audit work must be adequately planned.	1. The auditor must state in the report whether financial statements were prepared in accordance with generally accepted accounting principles.
2. The auditor must have independence of mental attitude.	2. The auditor must gain a sufficient understanding of the internal control structure.	2. The report must identify those circumstances in which generally accepted accounting principles were not applied.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. The auditor must obtain sufficient, competent evidence.	3. The report must identify any items that do not have adequate informative disclosures.
		4. The report shall contain an expression of the auditor's opinion on the financial statements as a whole.

Auditor Ethics and Legal Liabilities

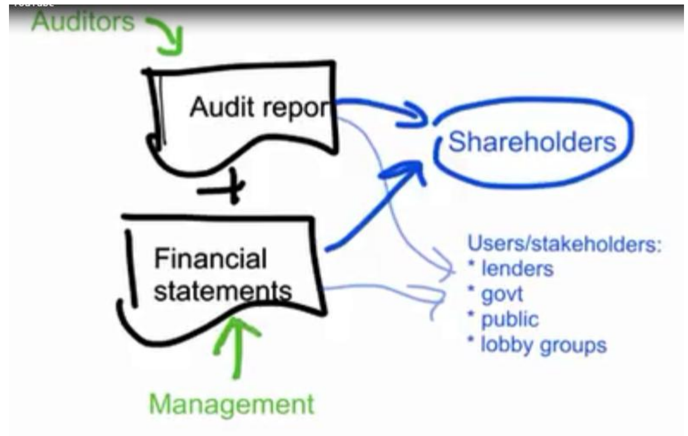
- ***OBJECTIVES***

- At the end of this point you will be able to:
  - ✓Define what ethics is
  - ✓Comprehend the need for professional ethics
  - ✓Understand professional ethics of auditors
  - ✓Describe legal liabilities of auditors

Reports produced by an entity and users

Amelaku B. 29

Who produces reports?



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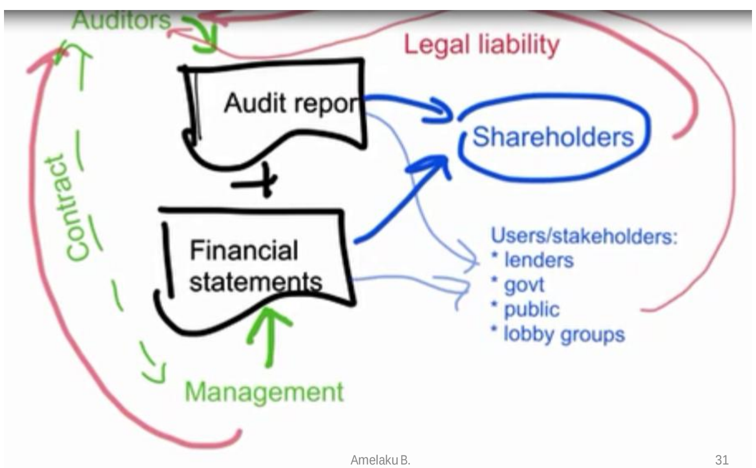
People's involved in audit report



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What Are Ethics?

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

- "Ethics in its broader sense, deals with human conduct in relation to what is <u>morally good and bad, right and wrong.</u>

Each of us has such a set of values.

We may or may not have considered them explicitly.

Amelaku B. 32

Source of Ethics

- Religion
- life experiences,
- successes and failures
- influences of parents, teachers, and friends
- Examples of Ethics
  – Respect
  – Trustworthiness
  – Responsibility
  – Caring.....

Need for Ethics

- Ethical behavior is necessary for a society to function in an *orderly* manner.
- The need for ethics in society is sufficiently important that many commonly held ethical values are incorporated into laws.

Why People Act Unethically?

- 1. The person's ethical standards are different from those of society as a whole.
  – *Eg.* drug dealers, bank robbers, and cheat on their tax returns, treat other people with hostility, lie on resumes and employment applications,
- 2. The person chooses to act selfishly.
- A considerable portion of unethical behavior results from *selfish behavior*

Rationalizing Unethical Behavior

- Everybody does it
- If it's legal, it's ethical
- Likelihood of discovery and consequences

Ethical Dilemmas

- An ethical dilemma is a situation a person faces in which a decision must be made about appropriate behavior.

Resolving Ethical Dilemmas

- 1. Obtain the relevant facts
- 2. Identify the ethical issues from the facts
- 3. Determine who is affected
- 4. Identify the alternatives available to the person who must resolve the dilemma
- 5. Identify the likely consequence of each alternative
- 6. Decide the appropriate action

Special Need for Ethical Conduct in Professions

- Our society has attached a special meaning to the term professional.
- Professionals are expected to conduct themselves at a higher level than most other members of society.
- The term **professional** *means a responsibility for conduct that extends beyond* satisfying individual responsibilities and beyond the requirements of our society's laws and regulations.
- A CPA, as a professional, recognizes a responsibility to the public, to the client.

Why professionals conduct at higher level??

- **Why professionals are expected to conduct themselves at higher level than most other member of society?**
- The reason for an expectation of a high level of professional conduct by any profession *is the need for public confidence in the quality of service by the profession.*
- For the CPA, it is essential that the client and external financial statement users have confidence in the quality of audits and other services.
- If users of services do not have confidence in physicians, judges, or CPAs, the ability of those professionals to serve clients and the public effectively is diminished.

Why professionals conduct at higher level??

- Which one makes your feeling more disappointed? Crime made by Doctor, Auditor. Why?
- **What makes audit profession differ from other professionals?**
- CPA firms have a *different relationship with users* of financial statements than most other professionals have with their customers.
- *Often*, the auditor does not know or have contact with the financial statement *users* but has frequent meetings and ongoing relationships with *client personnel.*
- *Thus*, so as to get public confidence over the services they provide to the users the auditor should strive to conduct the profession at higher level than other professions.
- It is essential that users regard CPA firms as competent and unbiased.

Amelaku B. 41

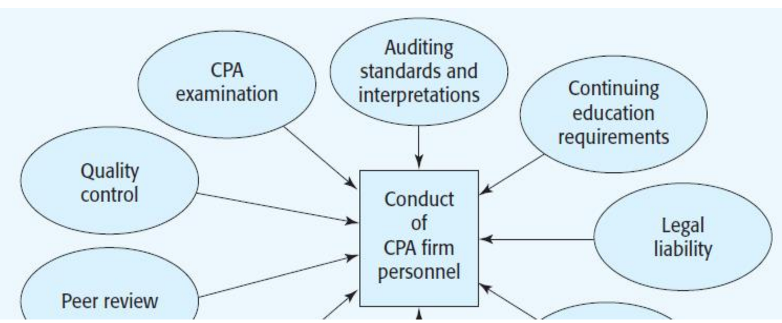
Special Need for Ethical Conduct in Auditing

- *In general*:
- The purpose of professional ethics in auditing is to:
  - ❑ build public confidence
  - ❑ judge the quality of audit work
  - ❑ Means of grounding guidance for practitioners

Amelaku B. 42

Ways CPAs Are Encouraged to Conduct Themselves Professionally

- **What are the ways that encourage CPAs to conduct themselves professionally?**
- i.e. ways CPAs can conduct themselves appropriately and perform high-quality audits and related services.



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Fundamental Principles of Professional Ethics (IAASB)

1. INTEGRITY
2. OBJECTIVITY
3. PROFESSIONAL COMPETENCE AND DUE CARE
4. CONFIDENTIALITY
5. PROFESSIONAL BEHAVIOUR

Amelaku B. 44

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

1. **INTEGRITY**
   - To be straightforward and honest
2. **OBJECTIVITY**
   - Not allow personal feelings or prejudices to influence professional judgement
   - Be unbiased
   - Not allow conflict of interest or influence of others to impair decision process

Amelaku B. 45

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

3. **PROFESSIONAL COMPETENCE AND DUE CARE**
   - Maintain knowledge and skill at a level required by professional bodies,
   - Keep up-to-date with changes in regulations and standards,
   - Continue education and work experience,
   - Act diligently, taking care to complete each task thoroughly, document all work, finish on a timely basis

Amelaku B. 46

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

4. **CONFIDENTIALITY**
   - Refrain from disclosing information to people outside the workplace that is learned as a result of employment
   - *Exception* if legal requirement to disclose
   - Not allowed to use confidential information to their advantage or advantage of another person

Amelaku B. 47

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

5. **PROFESSIONAL BEHAVIOUR**
   - Comply with rules and regulations and do not harm reputation of the profession
   - Be honest in representations to current and prospective clients
   - Do not claim to provide services they cannot provide, or qualifications they do not possess, or experience they do not have
   - Do not undermine reputation of, or quality of work produced by, others

Amelaku B. 48

2. AUDITOR INDEPENDENCE

- **Independence** is the ability to act with integrity, objectivity and with professional scepticism (questioning mind)
- Lack of auditor independence impacts on credibility and reliability of the financial report
- The auditor must be, and be seen to be, independent

Amelaku B. 49

AUDITOR INDEPENDENCE

INDEPENDENCE OF MIND –

ability to act independently;

ability to make a decision free from bias, personal belief and client pressures.

Independence in appearance is the result of others' interpretations of this independence

Amelaku B. 50

THREATS TO INDEPENDENCE:

1. SELF-INTEREST
2. SELF-REVIEW
3. ADVOCACY
4. FAMILIARITY
5. INTIMIDATION

Amelaku B. 51

Self-interest threats may arise as a result of the ***financial or other interests*** of members or of immediate or close family that *will inappropriately influence* the professional accountant's judgment or behavior; such as:

Amelaku B. 52

Financial interest

- A financial interest exists where an audit firm has a financial interest in a client's affairs, for example, the audit firm owns shares in the client.
- The IAASB does not allow the following to own a *direct financial interest* or an *indirect material financial* interest in a client:
  - The audit firm
  - A member of the audit team
  - An immediate family member of a member of the audit team
- The following *safeguards* will therefore be relevant:
  - Disposing of the interest
  - Removing the individual from the team if required
  - Keeping the client's audit committee informed of the situation
  - Using an independent partner to review work carried out if necessary

Close business relationships

- arise from commercial relationships or common financial interests.
  - Purchase, sale
  - Distributor or marketer of products and services of either party
  - Having a financial interest in a joint venture
  - Arrangements to combine one or more services or products
- *NB:* purchasing goods and services from an audit client on an *arm's length basis* does not constitute a threat to independence, *but* needs to judge the *materiality*, *nature* or *magnitude* that they create a self-interest threat.
- Appropriate safeguards are
  - to end the assurance provision or
  - to terminate the (other) business relationship

Employment with an audit client

- staff might transfer between an audit firm and a client; may result
  - An audit staff member might be motivated by *a desire to impress a future possible employer*
  - Would has too much knowledge of the audit firm's systems and procedures
- If a *'significant connection'* still remains between the audit firm and the former employee/partner, then *no safeguards* could reduce the threat to an acceptable level.

Employment with an audit client

- If there is *no significant connection*, then the threat depends on:
  - I. The position the individual has taken at the client
  - II. Any involvement the individual will have with the audit team
  - III. The length of time since the individual was a member of the audit team or partner of the firm
  - IV. The former position of the individual within the audit team or firm
- Safeguards could include:
  - I. Modifying the audit plan
  - II. Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client
  - III. Having an independent professional accountant review the work of the former member of the audit team

Temporary staff assignments

- Staff may be loaned to an audit client, but only for a short period of time. Staff must *not assume management responsibilities*
- Possible safeguards include:
  - Conducting an additional review of the work performed by the loaned staff
  - Not giving the loaned staff audit responsibility
  - Not including the loaned staff in the audit team

Partner on client board

- A partner or employee of an audit firm should not serve on the board of an audit client.
- It may be acceptable to perform the role of company *secretary* for an audit client, if the role is essentially *administrative*.

Family and personal relationships

- between audit firm and client staff
- Factors to be considered are:
  - The individual's responsibilities on the audit engagement
  - The closeness of the relationship
  - The role of the other party at the audit client
- Appropriate safeguards
  - removed from the audit team
  - undertaking a quality control review of the audit

Compensation and evaluation policies

- When the audit team is evaluated on *selling non-assurance services* to the client
- Safeguards include:
  - Revise the compensation plan and evaluation or
  - Having the team member's work reviewed by a professional accountant
  - A key audit partner shall not be evaluated or compensated based on their success in selling non-assurance services to their audit client

Gifts and hospitality

- Unless the value of the gift/hospitality is *insignificant and inconsequential*, a firm or a member of an audit team should not accept.

Loans and guarantees

- If bank
  - If a lending institution client (eg a bank) lends an *immaterial amount* to an audit firm or member of assurance team on *normal commercial terms*, there is *no threat* to independence.
  - If the loan is *material,* a suitable safeguard is likely to be an *independent review* , to bring the risk to an acceptable level.
- If not a bank
  - An audit firm should not enter into any loan or guarantee arrangement with a client that is *not a bank* (unless immaterial to both parties which is unlikely)

Overdue fees

- When fees due from an audit client remain unpaid for a long time
- If significant, considered as making a loan to a client

Contingent fees

- *Contingent fees* are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.
- It is inappropriate to accept a contingent fee for assurance and non-assurance work from an audit client, as it will create a self-interest threat.

High percentage of fees

- When a firm receives a high proportion of its fee income from just one audit client
- This depends on:
  - The operating structure of the firm
  - Whether the firm is established or new
- Possible safeguards include:
  - Reducing the dependency on the client
  - External quality control reviews
  - Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments.

Amelaku B. 65

Lowballing

- When a firm quotes a significantly lower fee level for an audit service than would have been charged by the predecessor firm.
- apply safeguards, such as:
  - Maintaining records such that the firm is able to demonstrate that *appropriate staff and time* are allocated to the engagement
  - *Complying with* all applicable auditing standards, guidelines and quality control procedures

Amelaku B. 66

2. Self-review threat

- Self-review threats arise when members *review their own work* or advice (providing non-assurance servies)

Amelaku B. 67

Recent service with an audit client

- Individuals who have been
  - a director or officer of the audit client, or
  - an employee in a position to *exert direct and significant influence* over the preparation of the accounting records or financial statements in the period covered by the audit report,
  - closely involved with the client
- appropriate safeguards, such as:
  - Obtaining a quality control review of the individual's work on the assignment
  - Discussing the issue with the audit committee
  - should not be assigned to the audit team

Amelaku B. 68

Provision of non-audit services in general

- Audit firms must evaluate any threat arising to provide a non-audit service, but a firm is not permitted to assume a *management responsibility* for an audit client.
- Such as in a responsibility of:
  - Setting policies and strategic direction
  - Directing and taking responsibility for the actions of the entity's employees
  - Authorizing transactions
  - Deciding which recommendations of the firm or other third parties to implement
  - Taking responsibility for the preparation and fair presentation of the financial statements
  - Taking responsibility for designing, implementing and maintaining internal control

Preparing accounting records and financial statements

- Except in *emergency situations*, a firm must not provide for any *public interest audit client*
  - accounting and bookkeeping services, including
    - payroll services, or
    - prepare financial statements on which the firm will express an opinion.

Valuation services

- Valuation means compute a certain value, or range of values, for an asset, a liability or for a business as a whole.
- Audit firms *should not carry out valuations* on matters which will be material to the financial statements which involve a significant degree of subjectivity.
- If the valuation is for an *immaterial* matter, the audit firm should *apply safeguards* to ensure that the risk is reduced to an acceptable level.
- Safeguards include:
  - Second partner review
  - Confirming that the client understands the valuation and the assumptions used
  - Ensuring that the client acknowledges responsibility for the valuation
  - Using separate personnel for the valuation and the audit
- *Note* that for a public interest client the degree of subjectivity is irrelevant.

Taxation services

- The Code divides taxation services into four categories.
- (i) Tax return preparation - does not threaten independence
- (ii) Tax calculations for the purpose of preparing the accounting entries - safeguards are applied (for non public interest entities)
- (iii) Tax planning and other tax advisory services – acceptable in certain circumstances
- (iv) Assistance in the resolution of tax disputes - safeguards are applied

Internal audit services

- An audit firm's personnel must not assume a *management responsibility* as a result of providing internal audit services.
- For internal audit services that are permitted but still create a threat it may be appropriate to use safeguards, such as
  - using personnel *not involved* in the audit,
  - *ensuring* that an employee of the client is designated responsible for *internal audit activities* and
  - *ensuring* that the client approves *all the work* that internal audit does.

Amelaku B. 73

AUDITOR INDEPENDENCE THREATS

3. ADVOCACY THREAT

- Can occur when an audit firm or assurance staff act, or is believed to act, on behalf of assurance client
- Can lead to questioning of auditor's objectivity
- Examples:
  - Encouraging others to buy client's shares or bonds
  - Representing client in negotiations with third party
  - Representing the client in a legal dispute

Amelaku B. 74

AUDITOR INDEPENDENCE THREATS

4. FAMILIARITY THREAT

Having an *audit client for a long period of time* may create a familiarity threat to independence

Possible safeguards include:

- ❑ Rotating the senior personnel off the audit team
- ❑ Having a professional accountant who was not a member of the audit team review the work of the senior personnel
- ❑ Regular independent internal or external quality reviews of the engagement

Amelaku B. 75

AUDITOR INDEPENDENCE THREATS

5. INTIMIDATION THREAT

- Can occur when member of assurance team feels threatened by the client's staff or directors
- Assurance team member unable to act objectively, fearing negative consequences
- Examples:
  - The firm is then faced with the *risk of losing the client*,
  - bad publicity and
  - the possibility that it will be found to have been negligent

safeguards could be considered:

- Disclosing to the audit committee the nature and extent of the litigation
- Removing specific affected individuals from the engagement team
- Involving an additional professional accountant on the team to review work

Amelaku B. 76

In General

SAFEGUARDS TO INDEPENDENCE

1. **Created by profession, legislation or regulation**
   - Quality control standards
   - Code of ethics
   - Legislative requirement to be independent
2. **Created by clients**
   - Corporate governance
   - Policies and procedures
3. **Created by accounting firms**
   - Quality control procedures
   - Client acceptance and continuance

Amelaku B. 77

Disadvantages of safeguarding independence

- What can the auditor do to preserve objectivity?
- Auditors would be to *withdraw from any engagement where there is the slightest threat* to objectivity.
- However, there are disadvantages in this strict approach.
  – Clients may lose an auditor who knows their business.
  – It denies clients the freedom to be advised by the accountant of their choice.

Amelaku B. 78

Auditors Responsibility and Legal Liabilities

- Professionals have always been required to provide a ***reasonable level of care*** while performing work for those they serve, that is why they set a governing standards.
- The auditor are expected to discharge his/her duties according to ***"Internationally Accepted Auditing Standards"*** if not, they are liable to their clients.
- Auditors are legally liable under *common law* and *statutory law* and *criminal law* to their *clients* and *third parties*.

Amelaku B. 79

Business Failure, Audit Failure and Audit Risk

- Currently the *number of lawsuits* and sizes of plaintiffs becomes *increasing/remains high* between auditors and its clients.
- *A major cause of lawsuits against CPA firms:*
- is financial statement users' ***lack of understanding*** of two concepts:
  - *The difference between a business failure and an audit failure*
  - *The difference between an audit failure and audit risk*

Amelaku B. 80

Business Failure, Audit Failure and Audit Risk

- ***A business failure:***
  - occurs when a business is *unable to repay* its lenders or meet the expectations of its investors because of economic or business conditions,
  - such as a recession, poor management decisions, or unexpected competition in the industry.
- ***Audit failure***
  - occurs when the auditor issues an incorrect audit opinion because it failed to comply with the requirements of auditing standards.
  - *For example:* a firm assigning ***unqualified assistants*** to perform certain audit tasks where they *failed to notice* material misstatements in the client's records that a qualified auditor would have found.

Amelaku B. 81

Business Failure, Audit Failure and Audit Risk

- ***Audit risk***
  - represents the possibility that the auditor concludes after conducting an *adequate audit* that the financial statements were fairly stated when, in fact, they were materially misstated.
  - Audit risk is ***unavoidable***, because auditors gather evidence only on a *test basis* and because well-concealed frauds are extremely difficult to detect.
- An auditor may fully comply with auditing standards and still fail to *uncover* a material misstatement due to fraud.

Amelaku B. 82

Business Failure, Audit Failure and Audit Risk

- When an audit has failed to uncover material misstatements and the wrong type of audit opinion is issued (*in case of audit risk*), ***it is appropriate*** to question whether the auditor exercised ***due car***e in performing the audit.
- *In cases of audit failure*, the law often allows parties who suffered losses to *recover* some or all of the losses caused by the audit failure.

Amelaku B. 83

Business Failure, Audit Failure and Audit Risk

- This conflict between statement users and auditors often arises because of an ***"expectation gap"*** between users and auditors.
- many users believe that auditors
  - ➢ guarantee the accuracy of financial statements, and
  - ➢ guarantees the financial viability of the business. i.e the auditor is a guarantor or insurer of financial statements.
- However, the *expectation gap* often results in ***unwarranted*** lawsuits.
- ***NB.*** However, auditors must recognize that, in part, the claims of audit failure result from the hope of those who suffer a business loss to recover from any source, regardless of who is at fault.
- This ***expectation gap a***rise because of statement users lack of understanding about the *role of auditors* and the differences between *business failure*, *audit failure*, and *audit risk*.

Amelaku B. 84

LEGAL CONCEPTS AFFECTING LIABILITY

- *Prudent Person Concept*: is standard of due care that the auditor is expected *only* to conduct the audit with *due care*, and is not expected to be *perfect*.
  - *He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for* negligence, bad faith, or dishonesty, but not for losses consequent upon ***pure errors*** of judgment.
- ***Liability for the Acts of Others***:
  - If an employee performs improperly in doing an audit, the partners can be held liable for the employee's performance under the *laws of agency.*

Amelaku B. 85

Legal Terms Affecting CPAs' Liability

- When the auditor has failed to conduct an adequate audit, liability may depend on the level of negligence, which can range from *ordinary negligence* to *fraud*.
- ***Terms Related to Negligence and Fraud***
- *Ordinary negligence:*
  - Absence of reasonable care that can be expected of a person in a set of circumstances.
  - For auditors, it is in terms of what other competent auditors would have done in the same situation.
- *Gross negligence :*
  - Lack of even slight care, equivalent to reckless behavior, that can be expected of a person. Some states do not distinguish between ordinary and gross negligence.
- *Constructive fraud*
  - Existence of extreme or unusual negligence even though there was no intent to deceive or do harm. Constructive fraud is also termed *recklessness. Recklessness in the case of an audit is* present if the auditor knew an adequate audit was not done but still issued an opinion, even though there was no intention of deceiving statement users.
- *Fraud*
  - Occurs when a misstatement is made and there is both the knowledge of its falsity and the intent to deceive.

Amelaku B. 86

Legal Terms Affecting CPAs' Liability

- ***Terms Related to Contract Law***
- ***Breach of contract***
- Failure of one or both parties in a contract to fulfill the requirements of the contract.

- ***Third-party beneficiary***
- A third party who does not have privets of contract but is known to the contracting parties and is intended to have certain rights and benefits under the contract.
- A common example is a *bank* that has a large loan outstanding at the balance sheet date and requires an audit as a part of its loan agreement.

Amelaku B. 87

Sources of Legal Liability

- ***Two sources of auditor's legal liability:***
  - 1. Liability to clients
  - 2. Liability to third parties
    - –under common law
    - –under the federal securities laws
    - –Criminal liability

Amelaku B. 88

1. LIABILITY TO CLIENTS

- It is the most common source of lawsuits against CPAs includes:
  - failure to complete a non-audit engagement on the agreed-upon date/breach of contract
  - inappropriate withdrawal from an audit,
  - failure to discover an embezzlement (theft of assets) as a result of negligence in the conduct of the audit, and
  - breach of the confidentiality requirements of CPAs

Auditor's Defenses Against Client Suits

- The CPA firm normally uses one or a combination of four defenses when there are legal claims by clients:
- ***A. Lack of Duty***
  - The lack of duty to perform the service means that the CPA firm claims that there was no implied or expressed contract.
- ***For example***, the CPA firm might claim that misstatements were not uncovered because the firm did a review service, not an audit.
- A *well-written engagement letter* significantly reduces the likelihood of adverse legal actions.

- ***B. Non-negligent Performance***
- The CPA firm claims that the audit was performed in accordance with auditing standards. Even if there were undiscovered misstatements, the auditor is not responsible if the audit was conducted properly.
- The prudent person concept establishes in law that the CPA firm is not expected to be *infallible*.

Auditor's Defenses Against Client Suits

- ***C. Contributory Negligence***
  - Exists when the auditor claims the client's own actions that prevented the auditor from discovering the cause of the loss.
- ***For example***, the CPA firm had notified the client (preferably in writing) of a deficiency in internal control that would have prevented the theft but management did not correct it, the CPA firm would have a defense of contributory negligence.

- ***D. Absence of Causal Connection***
  - To succeed in an action against the auditor, the client must be able to show that there is a close ***causal connection between*** the auditor's failure to follow auditing standards and the damages suffered by the client.
- ***For example***, assume that an auditor failed to complete an audit on the agreed-upon date. The client alleges that this caused a bank *not to renew an outstanding loan*, which caused damages. A potential auditor defense is that the bank refused to renew the loan for ***other reasons***, such as the weakening financial condition of the client.

2.LIABILITY TO THIRD PARTIES /Foreseen Users/UNDER COMMON LAW

- ***Third parties include***
  - actual and potential stockholders,
  - vendors,
  - bankers and
  - other creditors, employees, and customers.
- A CPA firm may be liable to third parties if a loss was incurred by the claimant ***due to reliance on misleading financial statements***.

- ***For example,*** a bank is unable to collect a major loan from an insolvent customer and the bank then claims that *misleading audited financial statements* were relied on in making the loan and that the CPA firm should be held responsible because it failed to perform the audit with due care.

2. LIABILITY TO THIRD PARTIES /Foreseen Users/UNDER COMMON LAW

- ***NB:*** ordinary negligence is insufficient for liability to third parties because of the lack of *privity of contract between the third party and the* auditor, unless the third party is a *primary beneficiary (a known third party).*
- *However, the court pointed out that if fraud or gross negligence* on the part of the auditor, the auditor could be held liable to third parties who are not primary beneficiaries.

- ***Auditor Defenses Against Third-Party Suits***
- Three of the four defenses available to auditors:
  - lack of duty to perform the service (an appropriate defense)
  - non-negligent performance, and
  - absence of causal connection.
- *Contributory negligence* is ordinarily not available because a third party is *not in a position to contribute* to misstated financial statements.

Amelaku B. 93

THE PROFESSION'S RESPONSE TO LEGAL LIABILITY

- Activities to reduce practitioners' exposure to lawsuits:
  - Standard and rules setting
  - Establishing peer review requirements
  - Educating users
  - Sanctioning members for improper conduct and performance

Amelaku B. 94

Summary

- *Audit Ethics ➡ Threats To Independence (Ethics) ➡ Safeguarding Techniques ➡ Auditors Legal Liability ➡ Possible Auditors Defense To Legal Liability ➡ Ways Auditors Are Encouraged to Conduct Themselves Professionally*

Amelaku B. 95

Thank you!!

Amelaku B. 96