1. **Nature and purpose of an audit**

*Auditing* is an evaluation of a person, organization, system, process, enterprise, project or product. It 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. The above description shows that auditing is **not only** done on financial statements. We have environmental audits, human resource audits, and so on. In fact any system can be audited.

This course is concerned with *financial statement audits.* What is a financial statement audit?

**A financial statement Audit** is an independent examination of financial statements of an entity that enables an auditor to express an opinion whether the financial statements are prepared (in all material respects) in accordance with an identified and acceptable financial reporting framework (e.g. international or local accounting standards and national legislations). Such audits are conducted by CPA firms or Audit firms. This view of audit is presented by ISA 200 *Objective and General Principles Governing an Audit of Financial Statements*. The opinion to be expressed is whether the financial statements reflect *a true and fair view* or present *fairly in all material respects* the state of affairs of the business. True and fair presentation means that the financial statements are prepared and presented in accordance with the requirements of the applicable International Financial Reporting Standards (IFRS) and local pronouncements/legislations.   
  
You will note that this is a wide concept of a financial statement audit which can be applied to any entity, not just to limited companies. However, in this course, we are concerned primarily with audits of limited companies (often known as statutory or external audits). Any other audit applications will be clearly indicated for you.

* 1. **Demand for audits**
     1. **Agency theory**

A problem that has always existed at the time when management reports to the owners is whether or not the owners will believe the management. This is because the reports may contain errors, not disclose fraud, be inadvertently misleading, be deliberately misleading, fail to disclose relevant information, fail to conform to regulations, e.t.c. The solution to this problem of credibility in reports and accounts lies in appointing an independent person called an auditor to examine the financial statements and report on his findings. A further point is that modern companies can be very large with multi-national activities. The preparation of the accounts of such groups is a very complex operation involving the bringing together and summarizing of accounts of subsidiaries with differing conventions, legal systems and accounting and control systems. The examination of such accounts by independent experts who are trained in the assessment of financial information is of benefit to those who control and operate such organizations as well as to owners and outsiders.

* + 1. **Stakeholder hypothesis**

Besides shareholders, there are others with interests in the organization whose interests should be taken into account. Examples are creditors and the public whose taxes are used to bail out ailing firms. This is the basis for statutory audits.

* + 1. **Information hypothesis/ Transaction cost economics**

The information hypothesis asserts that investors demand information on current and future cash flows and the market value of assets and liabilities. This theory is based on the concept of “bounded rationality” and “homo economicus”. A person chooses the best option based on the available information. Auditing has an informative role by improving corporate reporting disclosures reducing the chance of errors and bias and contributing to the formation of investors’ expectations.

* + 1. **The insurance hypothesis**

It is a requirement of regulatory forces and government agencies that investors and other users get credible and reliable financial information data from corporations. Under the insurance hypothesis, shareholders, creditors and other users seek auditors’ protection and so this hypothesis is directly related to topics such as auditor liability, auditor litigation and the information in audit reports. The auditor acts as a guarantor, or insurer, against risk of loss. The auditor will take precautions against personal loss when providing this protection by performing a thorough examination.

* 1. **Distinction between accounting and auditing**

Accounting is the process of recording, classifying, summarizing and reporting financial information in a logical/systematic manner for the purpose of decision making. To provide relevant & reliable information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the financial statements. In auditing the financial statements, the concern is with determining whether the presented financial statements properly (true and fair) reflect the financial information that occurred during the accounting period. Since auditors are primarily concerned with the end result of this work i.e. do the financial statements show a true and fair view? In order to arrive at their conclusion the auditors must have a deep knowledge and understanding of accounting (including applicable accounting standards) and in practice, the directors will consult with the auditors as to appropriate accounting policies to follow.

* 1. **Types of audits and auditors**
     1. **External Audits.**

The external audit, conducted by external auditors seeks to test the underlying transactions that form the basis of the financial statements and form an opinion of whether such financial statements represent a true and fair view of the state of affairs of the entity in question. External auditors are external consultants appointed to conduct the external audit.

* + 1. **Internal Audits.**

Internal audit, conducted by internal auditors, on the other hand, seeks to advise management on whether its major operations have sound systems of risk management and internal controls. In most cases, internal auditors are employees of the organization being audited, although increasingly, internal audit services are being outsourced.

* + 1. **Government/ public sector Audits.**

These are audits of public entities, such as state corporations, ministries, departments’ and so on. In Kenya, such audits are done by the Kenya national audit office (KENAO), the Government of Kenya audit department, although they may at times be outsourced to external consultants.

* 1. **Classification of Audits**
     1. **Financial statement audits (refer to definition above)**

A financial statement Audit is an independent examination of financial statements of an entity that enables an auditor to express an opinion whether the financial statements are prepared (in all material respects) in accordance with an identified and acceptable financial reporting framework (e.g. international or local accounting standards and national legislations)

* + 1. **Operational audits**

This is the appraisal of the economy and efficiency with which resources are employed. It is also a review of operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations are being carried out as planned.

* + 1. **Compliance audits**

This is a review of the systems established to ensure compliance with those policies, plans, procedures, laws, regulations and important contracts that could have a significant impact on operations.

* + 1. **Information systems audits**

This process collects and evaluates evidence to determine whether the information systems and related

resources adequately safeguard assets, maintain data and system integrity and availability, provide relevant and reliable information, achieve organizational goals effectively, consume resources efficiently and have, in effect, internal controls that provide reasonable assurance that business, operational, and control objectives will be met and that undesired events will be prevented or detected and corrected in a timely manner.

* + 1. **Integrated audits**

This type of audit consists of a combination of financial, operational and compliance, and IS audits for an organization.

* + 1. **Forensic audits.**

The foremost aim of forensics is to establish the truth behind a particular situation by immediately capturing data to identify the perpetrator and establish proof for criminal proceedings to aid law enforcement. It also aids the organization in protecting the assets from future criminal activities and in gaining an understanding about the perpetrators and their actions.

**NB:** Note that, as noted earlier, any system can be audited. For this reason, the classification above may not be exhaustive.

* 1. **Services offered by auditors**
     1. **Assurance services**

An **assurance service** is an independent professional service that improves the quality of information for decision makers. Such services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used (e.g. Financial information) as the basis for their decisions. Assurance services can be done by CPAs or by a variety of other professionals. For example, Consumers Union, a non profit organization, tests a wide variety of products used by consumers and reports their evaluations of the quality of the products tested in Consumer Reports. The organization provides the information to help consumers make intelligent decisions about the products they buy.

One category of assurance services provided by Auditors is **attestation services**. An attestation service is a type of assurance service in which the audit firm issues a report about the reliability of an assertion that is made by another party. An example of an attestation service is when an auditor issues a report with an opinion as to whether the financial statements present fairly in all material respects the state of affairs in a corporation. Attestation services fall into five categories:

1. Audit of historical financial statements

2. Audit of internal control over financial reporting

3. Review of historical financial statements

4. Attestation services on information technology

5. Other attestation services that may be applied to a broad range of subject matter

There are different levels of assurance services, which include:

**Reasonable assurance**: It is a conclusion that the financial statements are not materially misstated. It is a relative term whose content depends upon the circumstances. Reasonable assurance is less than absolute assurance. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner’s conclusion.

**Absolute assurance**: It is a conclusion that the financial statements are not misstated at all, meaning that audit risk is ZERO. This is impossible to arrive at due to the use of selective testing (sampling), inherent limitations of internal control, the fact that much of the evidence available to the auditor is persuasive rather than conclusive, the use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence, and the characteristics of the subject matter.

**Limited assurance engagement**: This term is associated with engagements in which the decision was taken to obtain less assurance than otherwise could have been reasonably obtained.

* + 1. **Non- assurance services provided by Auditors**

Audit 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

Most accounting and bookkeeping services, tax services, and management consulting services fall outside the scope of assurance services, although there is some common area of overlap between consulting and assurance services. While the primary purpose of an assurance service is to improve the quality of information, the primary purpose of a management consulting engagement is to generate a recommendation to management.

* 1. **Rights, duties and liabilities of auditor   
     1.6.1. Powers/Rights of an Auditor**i) Right of access to books of account and vouchers.   
     ii) Right to receive information and explanations.   
     iii) Right of access to books and papers of branch.   
     iv) Right to receive notices of general meetings and to attend those meetings.   
     v) Right to make representation where another person is being appointed as auditor.

vi) Right of Lien- to retain books of accounts at his custody in case of unpaid dues by the audited.

1.6.2. **Duties of an Auditor**   
Duties of auditor are:   
i) To give a report to the members on the accounts, books of account, balance sheet and profit and loss account examined by him.   
ii) Where any matter reported upon is answered in the negative or with a qualification the report shall include reasons for such qualification with factual position.   
iii) To include in the report of the company such matters as directed by the Government.   
iv) To attend those general meetings of a listed company, either himself or through authorized person, in which the balance sheet, profit and loss account and the auditors' report are to be considered.   
a. To make report for inclusion in prospectus.   
b. To certify receipts and payments account in the statutory report.   
c. To make report on declaration of solvency in case of voluntary winding up.   
d. To exercise reasonable care and skill in carrying out his duties and make such inquiries as considered necessary.

1.7. **Appointment:**

**1.7.1. First Auditors**

a) The first auditors of a company shall be appointed by the directors within 60 days of incorporation of the company.

b) The first auditors will hold office till the first annual general meeting.

c) If the directors fail to appoint the first auditors, the members shall appoint the first auditors, provided further that the auditors such appointed shall not be removed during the tenure expect through a special resolution.

d) Where the first auditors are not appointed either by the directors or by the members within 120 days of incorporation of the company, the Registrar of companies will appoint the auditor.

**1.7.2. Subsequent Auditors**

(a) At each annual general meeting the company (members) shall appoint the auditors.

(b) The auditors shall hold office from the conclusion of that meeting till the conclusion of next annual general meeting.

(c) If no auditors are appointed at annual general meeting Registrar of companies shall appoint an auditor.

**1.7.3. Casual Vacancy**

a) Any casual vacancy shall be filled by directors.

b) Auditors so appointed shall hold office till next annual general meeting.

c) If directors do not appoint auditors to fill casual vacancy within 30 days, The Registrar may appoint an auditor.

**1.7.4. Disqualification of Auditors**

Following persons are not qualified to become auditors of a company:

i) Present directors, other officer or employees of the company or who held these offices during the last three years.

ii) A partner or employee of a director, other officer or employee of the company.

iii) A spouse of a director.

iv) A person who is indebted to the company.

v) A body corporate (company) - NB: an auditor cannot be a company. It is always an individual..

vi) A person or his spouse or minor children or in case of firm all partners of such firm who holds any shares of an audit client or any of its associated companies.

* 1. **Liabilities of an auditor**

Professionals have always been required to provide a reasonable level of care while performing work for those they serve. Under common law, audit professionals have a responsibility to fulfill implied or expressed contracts with clients. Should auditors fail to provide the services or not exercise due care in their performance, they are liable to their clients for negligence and/or breach of contract, and, in certain circumstances, to parties other than their clients. Note that the liability of an auditor is personal, i.e. it is an individual auditor who is held liable- and that a company/ corporate body cannot be an auditor. The Auditors’ Liabilities fall under,

• Civil Liabilities (arising from law suits/Liability for negligence)

* Under law of contract.
* Under law of tort.

• Criminal Liabilities

* + Against charges of forgery (evidence created / documents forged etc.)
  + Against false statement (regarding opinion in the report)
    1. **Civil Liabilities**

Civil liabilities arise in the situation when there is absence of reasonable care and skill that can be expected of a person in a set of circumstances. When negligence of an auditor is being evaluated, it is in terms of what other competent auditors would have done in the same situation

* + - 1. **Duty of care under contract Law**

The company has a contract with the auditor and hence can sue the auditor for breach of contract if the auditor is negligent in carrying out the terms of the contract. Note that only the company can sue the auditor in contract as other people, such as banks, creditors and shareholders are not in a contractual relationship with the company.

• When carrying out their duties the auditors must exercise reasonable care and skill. This is required by the accountant’s rule of professional conduct.

• Members should carry out their professional work with due skill, care diligence and expedition and with proper regard for the technical and professional standards expected of them as members.

• The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care; the auditor is respected to react to the situation and circumstances he is facing

Breach of contract

A contract breaches when failure of one or both parties in a contract to fulfil the requirements of the contract arises. An example is the failure of a CPA firm to deliver a tax return on the agreed upon date. Parties who have a relationship that is established by a contract are said to have privity of contract. Typically, CPA firms and clients sign an engagement letter to formalize their agreement about the services to be provided, fee, and timing. There can be privity of contract without a written agreement, but an engagement letter defines the contract more clearly. The most common source of lawsuits against auditors is from clients. The suits vary widely, including such claims as failure to complete a non audit engagement on the agreed-upon date, inappropriate withdrawal from an audit, failure to discover an embezzlement (theft of assets), and breach of the confidentiality requirements of auditor. Typically, the amount of these lawsuits is relatively small, and they do not receive the publicity often given to suits involving third parties.

The auditor may defend himself or herself by citing the lack of express or implied contract (lack of duty), claiming that the audit was conducted as per the auditing standards (non- negligent performance), citing contributory negligence by the audited, and showing lack of causal connection between auditors failure to perform audit to the required standards and the loss suffered by the client.

* + - 1. **Tort action of negligence**

This arises from failure of auditors to meet their obligations, thereby causing injury to another party (other than audit client). The auditor generally owes a duty of care to third parties who are part of a limited group of persons whose reliance is “foreseen” by the auditor. A typical tort action against a CPA firm is a bank’s claim that an auditor had a duty to uncover material misstatements in financial statements that had been relied on in making a loan.

*Jeb Fasteners v Marks Bloom (1980)*

The plaintiff acquired the share capital of the company. The audited accounts, due to the negligence of the auditors, did not show a true and fair view of the state of affairs of the company. It was accepted that at the time of the audit the defendant auditors did know of the plaintiffs but did not know that they were contemplating a takeover bid.

Whilst recognizing that the auditors owed a duty of care in this situation. It was decided that the auditors were not liable because the plaintiff had not suffered any loss. It was proved that the plaintiffs would have bought the share capital of the company at the agreed price whatever the accounts had said. Therefore, whether or not a duty of care existed was not directly relevant to the decision.

*Rusch Factors v. Levin (1968)*

The plaintiff, Rusch Factors, a lender, asked the defendant auditor to audit the financial statements of a company seeking a loan. The auditor, Levin, issued an unqualified opinion on the financial statements, indicating that the company was solvent when, in fact, it was insolvent. The plaintiff loaned the company money, suffered a subsequent loss, and sued the auditor for recovery.

The auditor’s defence in the case was based on the absence of privity on the part of Rusch Factors. The court found in favour of this plaintiff. Although the court could have found in favour of Rusch Factors under Ultra mares in that it was a primary beneficiary, it chose to rely on the Restatement of Torts, stating that the auditor should be liable for ordinary negligence in audits where the financial statements are relied on by actually foreseen and limited classes of persons.

* + 1. **How to minimize the liabilities**

Specifically, practicing auditors may also take specific action to minimize their liability. Some of the more common actions are as follows:

The auditor may limit liabilities to third parties via, for example disclaimer statement.

Deal only with clients possessing integrity. There is an increased likelihood of having legal problems when a client lacks integrity in dealing with customers, employees, units of government, and others. A CPA firm needs procedures to evaluate the integrity of clients and should dissociate itself from clients found lacking integrity.

Maintain independence. Independence is more than merely financial. Independence requires an attitude of responsibility separate from the client’s interest. Much litigation has arisen from auditors’ too-willing acceptance of client representations or from client pressure. The auditor must maintain an attitude of healthy professional scepticism.

Understand the client’s business. In several cases, the lack of knowledge of industry practices and client operations has been a major factor in auditors failing to uncover misstatements.

Perform quality audits. Quality audits require that auditors obtain appropriate evidence and make appropriate judgments about the evidence. It is essential, for example, that the auditor understands the client’s internal controls and modify the evidence to reflect the findings. Improved auditing reduces the likelihood of failing to detect misstatements and the likelihood of lawsuits. In addition adhering to auditing standards helps improve the quality of audits.

Document the work properly. The preparation of good audit documentation helps the auditor perform quality audits. Quality audit documentation is essential if an auditor has to defend an audit in court, including an engagement letter and a representation letter that define the respective obligations of the client and the auditor. Exercise professional scepticism. Auditors are often liable when they are presented with information indicating a problem that they fail to recognize. Auditors need to strive to maintain a healthy level of scepticism, one that keeps them alert to potential misstatements, so that they can recognize misstatements when they exist.

It is also important for CPAs to carry adequate insurance cover and choose a form of organization that provides some form of legal liability protection to owners, e.g. a limited liability partnership.