**Chapter ONE**

**Overview of Auditing**

 **Introduction**

 Without question, the independent audit function plays an important role in both business and society. Numerous third parties, including investors, creditors, and regulators, depend on the competence and professional integrity of independent auditors.

Economic decisions are typically based upon the information available to the decision maker. To obtain the most benefit, users should have economic information that is both relevant and reliable. This need for relevant and reliable financial information creates a demand for accounting and auditing service.

 **1.1 Origin and historical development of Auditing**

The original meaning of the term Audit is derived from the Latin word ‘Audere’ which means ‘to hear’ and the term Auditor is ‘one who hear’. In earlier periods, commercial and governmental records were approved only after a public reading in which the accounts were read allowed to peoples those hear. From medieval period up to the industrial revolution Audit were performed to determine whether person in position of official responsibility in government and commerce were acting and reporting in an honest manner.

During the industrial revolution, manufacturing companies grew in size and their owners began to use the service of hired managers. With this separation of the ownership and management groups, the owners turned increasingly to the need of auditors to protect themselves from the danger of intentional error as well as fraud committed by managers and employees. Before 1900, consistent with this primary objective of detecting error and fraud, auditors often include a study of all, or almost all recorded transactions.

In the first half the 20th century, the direction of audit works tends to move away from fraud detection towards a new goal of determining whether financial statements give a full and fair picture of financial position, operating results, and change in financial position. Although banks were the primary users of financial reports, auditors become more responsible to stockholders, government agencies and to other parties who might rely up on financial information.

In the middle of 20th century, the large scale corporate entities growth rapidly, and auditory began to examine selected transaction rather than study all transactions. auditors and business managers gradually comes to accept the careful examination of relatively few transactions selected at random and they believe that it would be a cost effective and reliable indication of the accuracy of other similar transaction. In addition to sampling, auditors become aware of the importance of effective internal control. A company internal control consists of the policies and procedures established to provide reasonable assurance that the objective of the company will be achieved. Auditor found that by studying the firm’s internal control they could identify areas of strength and weaknesses. Now a days, Auditors began to use sophisticated computer soft ware to test the intensity of firm’s internal control and the accuracy financial statement balances.

The major auditing developments in the 20th century are sequentially listed as follows:

1. A shift in emphasis to the determination of fairness in financial statements
2. Increased responsibility of the auditor to third parties, such as governmental agencies, stock exchanges
3. A change in auditing method from detail examination of individual transactions to use of sampling techniques.
4. Recognition of the need to consider the effectiveness of internal control as a guide to the direction and amount of testing and sampling to be performed
5. Development of new auditing procedures applicable to computer systems and use of the computers as an auditing tool

  **1.2 Nature and definition of auditing**

 **Definition of Auditing**

What will be your answer if you asked to provide a complete definition of auditing and audit engagement?

Dear learners, it is quite difficult to give a single and precise definition of the term “Audit”. Many notable authors and other bodies have defined the word “audit”, and every one of them has attempted to emphasize one aspect or the other, but the central idea is more or less the same.

**Definition 1:** Some authors define auditing as **an independent examination of an expression of opinion on, the financial statements of a concern by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligations.**

**Definition 2:** Some scholars also define auditing as **an independent examination of the books of account and the related documentary evidence by a qualified person in order to ascertain the accuracy of figures.**

**Definition 3:** According to **Montgomery,** an American Accountant & auditors defined, **auditing is a systematic examination of the books and records of a business of other organizations in order to ascertain or verify and to report upon the facts regarding the financial operations and the results thereof.**

 **Definition-4**: A special committee of the American Institute of Accountants has defined the term ‘audit’ as follows:

“**An audit is an attest function where by a Certified Public Accountant (CPA) independently examine financial information of an entity and produce a report on the subject matter or an assertion about the subject matter which is the responsibility of another party ( e.g. Management).”**

To attest to information means to provide assurance as to its reliability. More formally, the AICPA has defined an attest engagement as one in which:

A practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

A financial statement audit is, by far, the most common type of attest engagement. However, CPAs attest to the reliability of a wide range of other types of information, including financial forecasts, internal control, compliance with laws and regulations, advertising claims, and the like.

The standards of the AICPA recognize three forms of attestation engagements. These are:

1. **Examination**- An examination referred to as an audit when it involves historical financial statements provides the highest form of assurance that CPAs provide.
2. **Review**- A review is substantially lesser in scope of procedures than an examination, and is designed to lend only a limited degree of assurance.
3. **Agreed upon procedures**-if an examination or review does not satisfy (meet) the clients needs, the CPAs and the specified users of the information may mutually decide on specified agreed upon procedures that the CPAs would perform.

**1.3 Demands for Audit**

There is a need for auditing when ownership is separated from control. At a practical level, it helps prevent or detect misstatements-errors or fraud. It may prevent or detect misstatements on the part of 1) the employees who actually handle the money, or 2) management. Auditing is needed to enhance the credibility of financial information prepared by an entity. The independent audit requirement fulfils the need to ensure that those financial statements are objective, free from bias and manipulation and relevant to the needs of users. The major reasons for increase in demand of auditing are:

1. **Control Mechanism**

Audits whether internally or externally performed are valued as important control mechanisms for accountability the overall need for monitoring activities, especially financial activity includes the need for auditing to provide credibility for reported and unreported information.

1. **To resolve Conflict of Interest**

The agency relationship that exists between an owner and manager produces a natural conflict of interest because of the information asymmetry that exists between the manager and the absentee owner. Information asymmetry means that the manager generally has more information about the "true" financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximize their own self-interest, it is likely that the manager will not act in the best interest of the owner.

Whenever there is a conflict of interest between parties, the need for an arbiter or a non-partisan view is obvious. In financial affairs there are natural grounds for conflict of interest between information preparer and user, which can result in the production of a biased information data. Thus an audit is required for an objective review of the information.

1. **To reduce damaging consequences**

The ultimate objective and function of accounting is to provide information for economic decision-making. Information is used for decisions that have serious and substantial economic consequences. Thus the need for an audit for verifying the accuracy of information before they are used in decisions that may bring damaging consequences.

1. **To simplify complexity**

In our age, financial information & translation has been come complex in preparation, content, and format. Therefore it demands drippy specialized body of knowledge to prepare (compilation), verify and interpret them.

1. **Regulatory Requirements**

Many business laws, memorandum of association and regulatory agencies acts make audits annual requirements to be complied with for renewal of license or permit. For example the security exchange commission (SEC) in the US; the Commercial Code of Ethiopia (1966), and latter the Public Financial Regulation of Procl 163/1999 in Ethiopia make the filing of audited financial statements annually. Disaster Prevention and Preparedness Commission (DPPC) requires NGOs to prepare and submit their annual financial statements. Thus compliance requirements create a very large demand for auditing services.

 **1.4 Accounting versus Auditing**

Many financial statement users and members of the general public confuse auditing with accounting. The confusion results because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by the fact that auditing is performed by individuals described as public accountants.

Accounting is the process of recording, classifying and summarizing economic events in a logical manner for the purpose of providing financial information for decision-making Accounting is constructive, It starts with the raw financial data to process and produce financial summary through reports known as financial statements as the end product of its work. The function of accounting, to an entity and to society as a whole, is to provide certain quantitative information that management and others can use to make decisions. To provide relevant information, accountants need to have a thorough understanding of the rules and principles and provide the basis for preparing the accounting information.

Auditing on the other hand is analytical work that starts with the end product of accounting to lend credibility and fairness of the measurements. In auditing, the concern is with determining whether recorded information properly reflects the economic events that occurred during the accounting period. Since the accounting rules and principles are the criteria for evaluating whether the accounting information is properly recorded, any auditor involved with this data must also thoroughly understand the accounting rules and principles. In the context of the audit of financial statements these are generally accepted accounting principles (GAAP).

In addition to understanding accounting, the auditor must also possess expertise knowledge in the accumulation and interpretation of audit evidence, determining the proper audit procedures, sample size, particular items to examine, timing of the tests, and evaluating the results are unique to the auditor. It is this expertise that distinguishes auditors from accountants.

 **1.5 Types of Audits and Auditors**

#### **Types of Audits**

Audits are often viewed as falling into three major types:

1) Audits of financial statements,

2) Operational audits, and

3) Compliance audits.

**1. Audits of financial statements: -** The goal is to determine whether the financial statements have been prepared in conformity with generally accepted accounting principles.

**2. Operational audits: -** An operational audit is study of some specific unit of an organization for the purpose of measuring its performance. The operation of a unit can be evaluated for its effectiveness and efficiency.

**3. Compliance audits: -** Compliance audit determines whether the specified rules, regulations, or procedures are being carried out or followed.

#### **Types of Auditors**

The most known types of auditors are

1. Independent auditors,

2. Internal auditors,

3. Government auditors.

**1. Independent (external auditors): -** Independent auditors have no connection to the firm as an owner or employee/manager. The basic task of independent auditor is to confirm to the owners that the employees are correctly reporting on their financial position and performance.

**2. Internal auditor: -** An internal auditor is paid salary as employee on the organization that is being audits. He/she is responsible to appraise and investigation the performance of unit and/or units within the organization and give recommendation to top management.

**3. Government audit: -** The government auditor is paid a salary by the government. He/she is responsible to the legislature or executive.

 **The Nature of Auditing In Ethiopia**

In Ethiopia audits seem to be done primary on account of government regulation. For example, NGOS are audited because the assets of the NGOS are deemed a “national asset,” the use of which is ultimately accountable to the government of Ethiopia.

Auditing in Ethiopia could be viewed in five main areas.

1. **The office of the auditor general (OAG**)

The powers and functions of the office of the OAG are given through the proclamations that established it, its sphere of activity lies in government audit.

1. **The audit service corporation**. The duty and functions of this entity involve mostly commercial audits of commercial and productive enterprises wholly or partially owned by government.
2. **Private audit firms.**
3. **Ministry of finance audit and inspection**. Auditing activity in this area includes audit of ministries and government departments by MF auditors and inspectors, including tax audit by Inland Revenue authorities.
4. **‘Corporations’ and enterprises’ auditors**. These are audits performed by internal auditors within enterprise.