**Chapter Two**

**THE AUDITING PROFESSION**

This unit covers the basic codes of professional conduct, which the auditors need to bear in mind in carrying out their duties. The main source of material for code of professional conduct in this unit is the AICPA’s code of professional ethics. Standards are established to measure the quality and performance of individuals and organizations. Standards relating to the auditing profession concern themselves both with the CPA’s professional qualities and with the judgment exercised by CPA’s in the performance of their professional engagement. Our purpose in this topic is to make clear the nature of generally accepted auditing standards (GAAS). In our discussion of GAAS, we consider mainly on the nature of the independent auditor’s report.

**2.1 Generally Accepted Auditing Standards (GAAS)**

The existence of GAAS is evidence that auditors are very concerned with the maintenance of a uniformly high quality of audit work by all independent public accountants.

What are the standards developed for the public accounting profession? The AICPA has set forth the basic framework in the following 10 generally accepted auditing standards.

**General Standards**

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

**Standard of field Work**

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of test to be performed.
3. A sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford reasonable bias for an opinion regarding the financial statements under audit.

**Standard of Reporting**

1. The report shall state whether the financial statements are presented in accordance with GAAP.
2. The report shall identify those circumstances in which such principle have not been consistently observed in the current period in relation to the preceding periods.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion can not be expended.

**Brief explanation of the above 10 GAAS standards**

1. **Training and Proficiency: -** How does the independent auditors achieve “adequate training and proficiency” required by the first general standard? This requirement is usually interpreted to mean college and University education in accounting and auditing, participation in continuing education programs, and substantial public accounting experience. It fallows that a CPA firm must not accept an audit engagement without first determining that members of its staff have the technical training and proficiency needed to function effectively in the particular industry.
2. **Independence**: - It states an opinion by an independent public accountant as to the fairness of the campaigns financial statements should be independent from other parties’ influence. If auditors owned share of stock in a company that they audited, or if they served as members of the board of directors, they might subconsciously be biased in the performance of auditing duties. A CPA should therefore avoid any relationship with a client that would cause an outsider who had knowledge of all the facts to doubt the CPA’S independence.
3. **Due professional Care: -** The third general standard requires due professional care in the conduct of the audit and in the preparation of the audit report. This standard requires the auditors to carry out every step of the audit engagement in an alert and diligent manner.
4. **Adequate planning and supervision: -** It is one of the standards of fieldwork related to accumulating and evaluating evidence sufficient for the auditors to express an opinion of the financial statements and adequate planning is essential to a satisfactory audit. The appropriate number of audits staff of varies level of skill and the time required of each need to be determined in advance of field work.
5. **Sufficient understanding of Internal Control: -** An effective internal control structure provides strong assurance that the client’s records are dependable and that its asset are protected when auditors find this types of strong internal control. The quantity of other evidence required is much less than if controls are weak. Thus the auditor’s assessment of internal control has great impact on the length and nature of the audit procures.
6. **Sufficient competent evidential matters: -** The third standard of field work regards that the auditors gather sufficient competent evidence to have a basis for expressing an opinion on the financial statements. The term competent refers to the quality of the evidence.
7. **Standards of reporting (7 to 10): -** The four reporting standards establish some specific directives for preparation of the auditor’s report. The report must specifically state whether the financial statements are in conformity with generally accepted accounting principles. The report must contain an opinion on the financial statement as a whole, or must disclaim an opinion.

**2.2 Professional Ethics and legal liability of auditors**

**Professional Ethics**

All recognized professions have developed code of professional ethics. The fundamental purpose of such codes is to provide members with gaudiness for maintaining a professional attitude and conducting themselves in a manner that will enhance the professional statues of their disciplines. Our purpose in this topic is to discuss the need for professional ethics in auditing profession.

**Need for professional Ethics**

To understand the importance of a code of ethics to public accountants and others professions, one must understand the nature of a profession as opposed to other vocations. There is no universally accepted definition of a profession but certain types of activities have been recognized as a profession such as medicine, law, engineering, architecture, and theology. Public accounting is a relative new comer to the ranks of the professions, but it has achieved widespread recognition in the recent decades.

All of the recognized professions have several common characteristics. The most important of these characteristics are-

1. A responsibility to serve the public
2. A complex body of knowledge
3. Standard of admission to the profession
4. A need for public confidence

Let us briefly discuss these characteristics as they are applied to public accounting

**Responsibility to serve a public**: - The certified public accountant is the representative of the public such as creditors, stockholders, consumers, employees, and others in the financial reporting process. The role of the independent auditors are to ensure that financial statements are fair to all parities and not biased to benefit one group at the expense of others. This responsibility to serve the public interest must be a basic motivation for the professionals. in addition, public accountants must maintain a high degree of independence from their clients (businesses those are under Audit) In order to serve the larger community.

**Complex body of knowledge**:- Any practitioner or student of accounting has only to look at the abundance of authoritative pronouncements governing financial reports to realize that accounting is a complex body of knowledge. One reason why such pronouncements continue to grow is that accounting must reflect what is taking place in an increasingly complex environment. The continual growth in the common body of knowledge “for practicing accountants” has led the AICPA to enact continuing education requirements for CPA’s.

**Standard of Admission in the Profession**: - a license to practice as a certified public accountant requires an individual to meet minimum standards for education and experience. The individual must also pass the uniform CPA examination showing mastery of the body of knowledge described above. Once licensed, certified public accountants must adhere to the ethics of the profession.

**Need for Public confidence**: Lawyers, physicians, certified public accountants, and all other professionals must have the confidence of the public to be successful. To the CPA, however, public confidence is of special significance and the CPA product is credibility. With out public confidence in the auditing practice, the attest engagement will serve no useful purpose.

**Professional ethics in public accounting**

Professional ethics in public accounting as in other professions have developed gradually and are still in a process of change as the practice of public accounting itself changes. This code of professional conduct for public accounting is developed by American institute of certified public accountant (AICPA). this code provides practical guidance to the individual members in maintaining a professional attitude. In addition, this code gives assurance to clients and to the public that the profession intends to maintain high standards and to enforce compliance by individual members in maintaining a professional attitude. In addition, this code gives assurance to clients and to the public that the profession intends to maintain high standards and to enforce compliance by individual members. These standards of conduct set forth the Basic responsibilities of CPAs to the public, clients. The AICPA code of professional conduct is designed to provide a framework for expanding professional services and responding to other changes in the profession, such as the increasingly competitive environment.

The AICPA code of professional conduct consists of two sections: - The first section, the principle, is goal oriented, positively stated discussion of the professions responsibility to the public, clients, and fellow practitioners. The principles provide the framework for the rules, which is the second section of the code. The rules are comfortable application of the principles. They define accountable behavior and identify source of authority for performance standards.

To provide guidelines for the scope and application of the rules, The AICPA issues interpretations. In addition, the AICPA issue Ethical rulings, which explain the application of the rules and interpretations to specific factual circumstance involving professional Ethics. A portion of the principle section of the code of professional conduct and rules are explained in detail as follows.

**Section 1 principles**

This principle of the code of professional conducts of the AICPA expresses the professionals’ recognition of its responsibilities to the public and to the clients. Generally the principles includes six article**s**

**Article 1-Responsibilities**

In caring out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all of their activates.

**Article 2- the public interest**

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust and demonstrate commitment to professionalism

**Article 3- Integrity**

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

**Article 4- objectively and independence**

A member should maintain objectivity and be free of conflict of interest in discharging professional responsibilities. A member in public practice should be independent when providing auditing and other attestation services.

**Article5- Due care**

A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the members’ ability.

Dear learners, members of CPAs in determining whether to provide specific service for clients should consider each of the above principles.

**Section II Rules**

The following figure shows the complete list of rules that are presented and analyzed in detail below.

**Rule**  **Title**

101 Independence

102 Integrity and objectivity

201 General standards

202 Compliance with standards

203 Accounting principles

301 Confidential client information

302 contingent fees

501 Acts Discreditable

502 Advertising and other form of solicitation

503 Commission and referral fees

504 (deleted)

505 Form of organization and name

**Rule 101** - **Independence**

A member in public practice shall be independent in the performance of professional service as required by standards promulgated by bodies designed by council.

**Rule 102 –** **Integrity and objectivity**

In the performance of professional service, a member shall maintain objectivity and integrity, shall be free of conflicting interest, and shall not knowingly misrepresent facts or subordinate disorder judgment to others.

**Rule 201 - General standards**

Member shall comply with the following standards;

* professional competence
* Due professional care
* Planning and super
* sufficient relevant data

**Rule 202 – Compliance with standards**

A member who performs auditing, review, compilation, management consulting, tax or other professional service shall comply with standards.

**Rule 203 – accounting principles**

A member shall not (1) express an opinion or state affirmatively that the financial statement or other financial data of any entity are presented in conformity with generally accepted accounting principles, or (2) sate that he or she is not aware of any material modifications that should be made to such statement or data in order for them to be in conformity with generally accepted accounting principles, if such statement or data contain any departure from an accounting principle.

**Rule 301- Confidential client information**

A member in public practice shal1 not discloses any confidential client information with out the specific consent of the client.

**Rule 302** – **Contingent fees**

A member in public practices shall not;

1. Perform for a contingent fee any professional service, or receive such a fee from a client for whom the members firm performs an audit or review of financial statements.
2. Prepare an original or amendment tax return or claim for a tax refund for a contingent fee for any client.

**Rule 501 Acts Discreditable**

A member shall not commit an act discreditable to the profession.

**Rule 502** **advertising and other form of solicitation**

A member in public practice shall not seek to obtain clients by advertising or other form of solicitation a manner that is false, misleading, or unreliable.

**Rule 503-** **commission and referral fees**

Prohibited commissions- A member in public practice shall not for a commission recommend or refer to a client any product or service, , when the member or the member’s firm performs an audit, review or examination of financial statements.

Disclosure of permitted commission- a member in public practice who is not prohibited by this rules from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose the fact to any persons a product or service to which the commission relates.

Referral fees- any member who accept a referral fee for recommending or referring any service of a CPA to any person or entity who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.

**Rule 505 form of organization and name.**

A member may practice public accounting in a form of organizations permitted by state low or regulations. However, any member shall not practice public accounting on the name of the firm.

* 1. **Legal liability of auditors**

In the previous sub topics we have seen professional standards and ethics regarding auditing profession. We believe also that you clearly understand such standards, ethical rules and principles those guide the auditing profession. Consequently, now let us see the auditors’ liability against their clients and third parties beneficiaries when they fail to obey and implement the above standards, ethical principles and rules.

**Basic terminologies**

Discussion of auditors’ liability is best preferable by first understanding basic terminologies of business law.

**Negligence-** it is also referred to as ordinary or simple negligence. For the CPA, negligence is failure to perform a duty in accordance with applicable standards. For practical purpose, negligence may be viewed as “failure to exercise due professional care”.

**Gross negligence** is lack of even slight care in caring professional service. It is substantial failure on the part of an auditor to comply with generally accepted auditing standards.

**Fraud** is defined as misrepresentation by a person of a material fact, known by that person to be untrue, with the intention of misleading the other party and with the result that the other party is injured.

**Constrictive fraud** it differs from fraud because it does not involves a misrepresentation with intent to deceive. Gross negligence from the side of auditor can be interpreted by the court as constrictive fraud.

**Privities** are the relationship between parties to a contract. A CPA firm is in privities with the client it is serving, and with any third party beneficiaries.

**Third party beneficiary** is a person- not the promisor or promise- who is named in a contract to have definite right and benefit under the contract. For example ABC and company, CPAs, is engaged to examine the financial statement of XYZ company and to send a copy of its audit report to Development Bank as support for a loan, the bank is a third party beneficially under the contract of ABC and co. and XYZ Company.

**An engagement letter**:- is the written contract summarizing the contractual relationship between auditor and clients.

**Breach of contract**:- is frailer of one or both parties to a contract to perform in accordance with contract provision

**The plaintiff**: - is the party claiming damages and bringing suit against the defendant.

**Contributory negligence**: - is negligence on the part of the plaintiff that has contributed to his or her having incurred a loss.

**Comparative negligence**:- is a concept used by certain courts to allocate damages between negligent parts based on the degree to which each party is at fault.

**Common law**: - is unwritten law that has developed through court decision; it represent judicial interpretation of a society’s concept of fairness for example, the right to sue a person for fraud is a common law right.

**Statutory low**: - is law that has been adopted by a governmental unit, such as the federal government.

**Auditors’ liability for their clients under common law**

Audition must design their audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. In doing so, they must exercise due care and professional skepticism in planning, performing, and evaluating the results of audit procedures. Auditors liability to their clients most often arises form a failure to uncover an embezzlement or defalcation (misappropriation of asset) against the clients by client employees. When CPAs take on any type of audit engagement, they are obliged to render due professional care. The obligation occurs whether or not it is specifically set it the written contract with the client. Thus, CPA’s are liable to their clients under common law for any losses caused by CPA’s failure to render due professional care. In short, ordinary negligence is a sufficient degree of misconduct to make CPA’s liable for damages caused to their clients. However, when the CPAs’ firm’s audit has been made in accordance with generally accepted auditing standards, the firm should not hold liable for failure to detect the existence of errors or irregularities.

To obtain a judgment against its auditors, an injured client must provide that it sustained a loss as a result of the auditors’ negligence. As defendants, the auditors can disprove this claim by showing that either.

1. They were not negligent in the performance of their duties, or
2. Their negligence was not the direct cause of the client loss.

Demonstrating contributory negligence by the client is one means of showing that the auditors negligence was not the cause (or sole cause) of the client’s loss. In some jurisdictions, a defense of contributory negligence will eliminate the auditors’ liability to their clients. In addition, the concept of contributory negligence is used to allocate damages between the clients and the auditors based on the extent to which each is at fault.

**Auditors’ liability to third parties under common law**

What do you think about auditors liability to third parties those rely up on audited financial statements? How these parties recover their losses from auditors’ those performed an improper audit?

Auditors could be liable to third party beneficiaries under common law. The degree of negligence required to establish the auditors’ liability to third parties under common law varies from one case to another. Dear colloquies, three general approaches may be used to summarize auditor’s liability to third parties under common law. There are:

1. Ultramar Approach
2. Restatement of torts Approach
3. Rosenblum Approach

**Ultramar Approach**

In this case, auditors are liable for ordinary negligence and for third parties if the users of audited financial statement are specifically identified, and they are liable for grass negligence even for unidentified third parties.

**Example:**

The defendant CPA has issued an audit opinion on the balance sheet of the company engaged in the importation and sale of rubber. On the bases of CPA’s opinion, **Ultramar’s** (the third party), made several loan to the company. Shortly there after, the company was declared bankrupt and ultra mares sued the CPA’s for ordinary negligence. Finally, the court decided that the CPA should be held liable for ordinary negligence only to their client and only third party beneficiary that are specifically identified as a user of the CPA’s repot. In addition, the court indicates that the auditors should be held liable to unidentified third party users of the audit report if there is Gross negligence or fraud.

Therefore, in order to cover a loss from CPA’s **ultra mares** should verify;

1. Whether the audit report is prepared for the consumption of the client and specifically identified third party.
2. The CPAs were grossly negligent in performing their audit.

**Restatement of torts Approach**

It is also referred to as the foreseen third –party approach. In this case CPA’s are liable for ordinary negligence to a limited class of fore seen third parties of known or intended user of the audited financial statements.

**Example:**

Girum and Company, CPA, perform the audit of Lyman Corporation. The CPA was aware that Lyman intended to use the audit report to obtain a bank loan. However, no specific bank was identified to the CPA-firm. After the report was issued, Lyman obtained loan from the Dashen bank and Awash bank. In addition, ABC manufacturing Company relied on Girum opinion in providing trade credit to Lyman. If the court applied the principles contained in the restatement Approach, Girum could be liable to Dashen and Awash bank if there is ordinary negligence in the performance of his audit. On the other hand, ABC manufacturing company would have to prove gross negligence on the part of Girum to recover its losses.

**Rosenblum Approach**

This Approach expand liability of auditors to third parties whether or not users of the audit report are specifically identified from the point of view of that audit report should avail correctly to all 3rd parties.

**Example:** Girum, CPA, issued an audit report on the financial statement of Giant Stores Corporation that showed the corporation to be profitable. In reliance up on these statements, ABC sold a catalog show room business to Giant in exchange for share of Giant stock. Shortly afterward, Giant filed for bankrupt and the stock become worthless. ABC suet Girum and the court decided that Girum, CPA firm, is liable for ordinary negligence even for unidentified third parties from the point of view of that audit report should be reliable for all types of users. (**Rosenblum** Approach)

**Auditor’s liability to third party under statutory law**

Statutory law is written law, created by state or federal legislative bodies-most countries have commercial law that regulate the trade and commercial activity of the country. Dear learners, auditors will be liable under statutory law when the injured third party could justify the relationship between the loss and the information provided with audit report.

**Auditors’ liability for accounting and review service**

Up to this point, we have emphasized the liability of CAP firms when they are associated with audited financial statements. In addition, CPAs are subject to legal liability when they perform accounting service such as write-up work and compilation of un audited financial statements. These services differ from audit engagement because the CPAs neither perform investigative procedures that involved in an audit engagement nor do they issue an auditors opinion as to the fairness of the financial information.

The term compilation refers to the preparation of financial statements based up on information provided to the CPA by the client. A compilation is not intended to lend any assurance to any party that the CPA has determined the information to be reliable. A review consists of limited investigative procedures, substantially less in scope than an audit, designed to provide uses of unedited financial statement with a limited degree of assurance as to the statements reliability.

Do CPAs associated with unaudited financial statements have any potential legal liability? The answer is yes. The CPAs, acting as accountants rather than as auditors, still have a liability to their client to exercise due professional care. In addition, they still may be liable under common law for losses to third parties attributable to the accountants’ ordinary and gross negligence.