**1. THE NATURE AND PURPOSE OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS**

**1.1 Objective of external audit and the concept of true and fair presentation**

The **objective of an audit** of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The **objectives of an auditor** of financial statements are:

1. To **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, in order to enable the auditor to express an opinion on whether they are prepared, in all material respects, in accordance with an applicable financial reporting framework.
2. To **report** on the financial statements, and communicate as required by the International Standards on Auditing (ISAs), in accordance with the auditor’s findings.

An applicable financial reporting framework is the applicable financial reporting standards and laws.

In Uganda, financial statements are audited to check their compliance with:

* International Financial Reporting Standards (**IFRSs**) and the Companies Act 2012 in the private sector.
* International Public Sector Accounting Standards (**IPSASs**) the Public Finance Management Act 2015 in the public sector.

Financial Reporting Standards (FRSs) and laws require management of an entity to prepare financial statements that show a true and fair view of (*or present fairly*) the financial position, financial performance and cash flows of an entity and are prepared in accordance with the applicable financial reporting standards and laws. An auditor audits the financial statements and expresses an opinion on whether they show a true and fair view of the financial position, financial performance and cash flows of an entity and comply with relevant FRSs and laws.

An audit is a process of collecting **audit evidence** on financial statements.

Audit evidence is information used by the auditor on which the auditor’s opinion is based.

Audit evidence is collected from accounting records underlying the financial statements and other information.

An auditor gives an independent **opinion** on the financial statements **in an audit report**.

**The concept of true and fair presentation**

An auditor expresses an opinion on whether financial statements give a true and fair view.

**True** means:

* Information in financial statements is factual and conforms with reality.
* The information conforms with the required financial reporting standards, laws and regulations.
* The financial statements have been correctly extracted from the books and records.

**Fair** means:

* Information is free from discrimination and bias and in compliance with expected standards and rules.
* Financial statements reflect the commercial substance of the entity's underlying transactions.

True and fair view is the same as fair presentation.

A matter is considered **material** if its omission or misstatement would reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. The auditor’s opinion deals with financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

Reasonable assurance is a **high level** assurance.

No auditor can give 100% assurance that the financial statements are free from material misstatements due to limitations of an audit.

The opinion in the audit report may be:

* An **unmodified opinion** (**an unqualified opinion**) that is issued when the auditor has:
* Not detected any material misstatements and financial statements comply with relevant IFRSs and laws.
* Collected sufficient appropriate evidence on the financial statements during the audit.
* **A modified opinion** that isissued when the auditor:
* Has detected material misstatements & financial statements do not comply with relevant IFRSs & laws.
* Has been unable to obtain sufficient appropriate audit evidence that financial statements are free from material misstatement (called **limitation on the scope of the audit**).
  1. **Demand for audit and the concepts of accountability, stewardship and agency**

There is demand for audit as it improves **accountability, stewardship and agency** (see diagram).

* **Accountability** is the state of being accountable i.e. being required to justify actions and decisions.
* **Stewardship** means the duties and obligations of a person who manages another person’s property.
* **Agents** are employed or used to provide a particular service.

c) Appoints an auditor to verify

financial statements

d) Makes an audit report giving

reasonable assurance

a) Owns the company & b) Prepares financial statements e) An independent audit

appoints its managers showing company performance adds credibility

Company managers are stewards of the shareholders’ investments. They are agents of shareholders. Managers are accountable to shareholders. They prepare financial statements showing their stewardship in managing the entity and provide accountability for investments to shareholders. Managers may mismanage the company. Therefore, shareholders appoint an independent auditor to audit the entity’s financial statements and issue a report to them. The auditor’s opinion enhances the **credibility** of the financial statements by providing **reasonable assurance** that the financial statements are free from material statements.

However, the auditing profession has come under public scrutiny due to financial scandals and sometimes corporate failure like Enron in USA and Crane Bank in Uganda despite having good audit reports. Society has questioned the effectiveness of an audit and such events have led to closer supervision of auditors. For example, the Institute of Certified Accountants of Uganda carries out regular inspection of audit firms.

**1.3 General principles of an audit (*Requirements of the auditor*)**

ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing* requires an audit to be performed in accordance with the following general principles:

1. **Compliance with the code of ethics** relating to an audit of financial statements issued by ICPAU and IFAC that requires an auditor to comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.
2. **Perform an audit in accordance with International Standards on Auditing (ISAs)** thatprovide the basic principles and essential procedures. An audit should comply with all the ISAs relevant to the audit engagement and an auditor is required to state whether the audit complies with all relevant ISAs.
3. **Professional scepticism** is an attitude of a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence. For example:
4. The auditor should be alert to conditions which may indicate possible fraud.
5. Audit evidence that contradicts other audit evidence.
6. Information that brings into question the reliability of documents and responses to questions.
7. Circumstances that suggest additional audit evidence is needed in addition to those per ISAs.
8. **Professional judgment** is the application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement. For example professional judgment is required in:
9. Determining the level of audit risk and setting materiality.
10. Determining the nature, timing and extent of audit procedures to be performed.
11. Evaluating whether sufficient appropriate evidence has been obtained.
12. **Sufficient appropriate audit evidence** should be obtained during the audit in order to obtain reasonable assurance and reduce audit risk to an acceptably low level to enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion.

**1.4 Types of auditing**

There are three main types of auditing i.e. financial, performance and compliance auditing. Other audits are forms of the three.

**Financial auditing**

Is an audit of financial statements of an entity whose objective is the expression of an opinion by the auditor as to whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (IFRSs or IPSASs and laws). This is the main type of auditing.

**Performance auditing**

* Performance auditing establishes whether an entity’s resources are used economically, efficiently and effectively and recommend ways for improvement.
* **Economy** means minimising costs for activities e.g. using pickup vehicles as hospital ambulances.
* **Efficiency** means getting the most output from available resources e.g. increasing the teacher/student ratio.
* **Effectiveness** means achieving objectives set e.g. providing free secondary education to all primary school leavers.
* Performance audit is also called operational audit or value for money (VFM) audit.
* Performance audit is mainly done in the public sector or not-for-profit entities to improve accountability and service delivery.

**Compliance auditing**

* Compliance auditing is an independent assessment of whether an entity complies with relevant laws, regulations and agreements.
* It includes compliance with procurement and human resource regulations.
* An environment audit by NEMA is an example of a compliance audit.
* It may be done separately or combined with financial or performance auditing.

**Comprehensive audit** usually combines financial, performance and compliance audits and is done to collect detailed evidence needed to restructure an entity or to carry out fraud investigations.

**Forensic audit**

* Is an independent investigation and gathering of evidence of the alleged financial fraud or mismanagement.
* It involves a detailed review of all relevant records and collection of supporting evidence for audit findings.
* Forensic audit is a specialist audit done by forensic auditors.
* Forensic auditors may testify in court except that it is the courts to determine fraud.

**External audit**

* Is an independent examination of financial statements by an external auditor.
* The objective is to enable the auditor to express an opinion on whether the financial statements give a true and fair view of the financial position, financial performance and cash flows of an entity in accordance with the relevant financial reporting standards and laws.
* Is done by firms of Certified Public Accountants (CPAs) or by the Office of the Auditor General.
* An external audit may be a statutory audit or a private audit.

**Statutory audit**

* Is an audit required by law.
* Company audit and public sector audit are statutory audits.
* The law specifies the nature of the audit and the contents of an audit report.
* An auditor states whether financial statements give a true and fair view and comply with IFRSs or IPSASs & relevant laws.

**Private audit**

* Is an audit not required by law like the audit of sole traders and many not-for-profit entities.
* Reasons for undertaking a voluntarily audit include:
* Providing assurance to the owners on the financial position and performance
* Making financial statements more acceptable to tax authorities like URA
* Making the sale of a business easier
* To enable entities obtain loans from lenders
* To meet the requirements of donors

**Internal audit**

* Is an assurance and consulting function designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.
* Is done by internal auditors who may be employees of the entity or the function may be outsourced.
* Internal auditors are not required to be registered CPAs.
* Varies from entity to entity but usually includes elements of financial, performance and compliance audit.
* Is statutory in listed companies, financial institutions and the public sector.

**Public sector audit**

* Is the audit of public sector entities like government ministries, districts, cities, towns and parastatals.
* Is done in accordance with IPSASs and the Public Finance Management Act by the Office of the Auditor General (OAG) or by private audit firms that are appointed and report to the OAG.
* Includes financial, performance and compliance auditing.
* Its objective is to improve accountability in the public sector.
* The OAG submits audit reports to Parliament of Uganda**.**

**Special purpose audits**

* Are audits in particular fields including the following:
* VAT audit by URA to check the accuracy of VAT returns.
* Engineering audit by UNRA to check whether roads have been constructed as per approved designs.
* Environmental audit by NEMA to check compliance with environmental laws
* Audit of goods by UNBS quality inspectors to check whether goods comply with the required standards**.**

**1.5 Limitations of auditing**

Auditors cannot certify that financial statements are 100% accurate but instead express an opinion that they free from material misstatements because of the following inherent limitations in every audit:

1. Auditing is **not objective** as judgment has to be made on risk assessment, what to test, how much to test, whether errors are representative of the population and in making an audit opinion.
2. Not all items in the financial statements are tested as auditors use **sampling** that has sampling risk**.**
3. Limitations in **accounting and control systems** like human error, the possibility of collusion in fraud and the possibility of controls override
4. Audit evidence is **persuasive** rather than conclusive like a delivery note may not always prove that goods were actually delivered.
5. An audit report may be issued a **long time after** the end of the reporting period and the up-to-date and historic positions may be different.

**1.6 Assurance engagements**

An **assurance engagement** is one where a practitioner obtains sufficient appropriate evidence in order to give a conclusion that increases the confidence of another party about a subject matter measured against criteria.

**Elements of an assurance** **engagement** **(CREST)**

1. **Criteria** that are used in assessing the subject matter in order to form an opinion e.g. the IFRSs.
2. **Report** containing the practitioner’s opinion issued to the intended user in an appropriate form.
3. **Evidence** that is sufficient and appropriate to be obtained to support the required assurance level.
4. **Subject matter** which is data that the responsible party has prepared that requires verification like financial statements or internal control processes.
5. **Three party relationship** comprised of:
   1. **The responsible party** is the party that prepares the underlying subject matter e.g. management
   2. **The practitioner** is the individual conducting the engagement like the engagement partner or other members of the engagement team or the firm.
   3. **The intended users** that the practitioner expects to use the assurance report e.g. the shareholders.

**Examples of assurance engagements**

1. Statutory audit of financial statements.
2. A review of interim financial statements.
3. Internal controls effectiveness review.
4. Cash flow forecasts review when applying for bank loans.
5. Compliance review for corporate governance, NEMA regulations and contracts.
6. Going concern review.

**Approach to conducting assurance reports**

1. Agree the **scope of work** with the client.
2. Formalize the terms of the engagement in a contract (**engagement letter**).
3. **Plan** the work required based on the risk and level of assurance required.
4. Obtain **sufficient appropriate evidence** on which to base the conclusion.
5. Perform **overall review** and **form opinion**.
6. Issue an **assurance report** to the client as per agreed format.

**Benefits of assurance reports**

1. Independent opinion **enhances the credibility** of the information.
2. Reduces **management bias**.
3. Any modified opinion draws attention to the **risk**.
4. **Improved relevance** of information because of the expertise of the practitioner.

**Levels of assurance**

There are two forms of assurance engagements:

* Reasonable assurance engagements
* Limited assurance engagements

**Reasonable assurance engagements**

1. These provide **high but not absolute** level of assurance.
2. **Sufficient and appropriate evidence** is collected using various types of procedures.
3. An **external audit** is an exampleof a reasonableassurance engagement.
4. The conclusion formed in any report is usually expressed in a **positive form**.
5. For example, ‘In our opinion, financial statements give a true and fair view of the financial position, financial performance and cash flows of the entity and comply with relevant IFRSs and the Companies Act ’.

**Limited assurance engagements**

1. This is a **lower level** of assurance.
2. **Limited procedures** like inquiry and analytical procedures are used to collect evidence.
3. A **review of financial statements** is an exampleof a limitedassurance engagement.
4. The opinion is expressed in a **negative form**.
5. For example, ‘Based on our work described in this report, nothing has come to our attention which indicates that the financial statements are materially misstated’.