Lecture 4

Ch. 11 - Ethics & Terms of Audit Engagements

(1) Ethics and Fundamental Principles

Meaning of Ethics

- Moral principles which govern a person's behaviour or his conducting of an activity.
- It is a state of mind to act & perform in accordance with moral principles.
- Ethics have manifold importance in profession of auditing like other professions of Law and medicine.
- CAs, whether in practice or in service, are required to comply with provisions of Code of Ethics.
- Any deviation from ethical responsibilities brings disciplinary mechanism into action against CAs which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

Principles Based Approach Vs Rules Based Approach to Ethics

- **Principles-based approach**: Requires compliance with **spirit of ethics.**

  Requires accountants to exercise professional judgment based upon:

  (1) Professional knowledge; and

  (2) Skill & expertise
- **Rule based approach**: Requires strict follow-up of established rules.

  Spirit of ethics may be overlooked.

  Rules-based approach is rigid as it may not be possible to deal with every practical situation relying upon rules.

Fundamental Principles of Professional Ethics

A professional accountant shall comply with each of the fundamental principles.

(A) Integrity

- Accountant to be straightforward & honest in all professional & business relationships.
- Integrity implies fair dealing and truthfulness.

- Professional accountant shall not knowingly be associated with reports, returns, communications or other information where he believes that:
  (a) information contains a materially false or misleading statement;
  (b) statements or info. provided negligently or omits required info. where such omission would be misleading.

(B) Objectivity

Auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

(C) Professional competence and due care

Accountant is required:

- to attain & maintain professional knowledge & skill at level required to ensure that professional work is performed in accordance with current technical & professional standards & relevant legislation; and
- act diligently, in accordance with applicable technical & professional standards.

Diligence includes responsibility to act carefully, thoroughly & on a timely basis.

(D) Confidentiality

- Respect confidentiality of information acquired as a result of professional or business relationships.
- Confidentiality serves public interest as it facilitates free flow of information from client to accountant with understanding that info. will not be disclosed to a third party.
- Information may be disclosed in following circumstances:
  (a) When required by law; or
  (b) If authorised by client or employer; or
  (c) There is a professional duty to disclose when not prohibited by law.

(E) Professional behaviour

Comply with relevant laws and regulations and avoid any conduct that accountant knows or should know might discredit the profession.

(2) Independence of Auditors

Concept of Independence

- Independence implies that judgement of a person is not subordinate to wishes or direction of another person who might have engaged him, or his own self- interest.
- Independence is a state of mind and personal character & not be confused with superficial & visible standards of independence which are sometimes imposed by law.

Perspectives of Independence - 2

- **Independence of mind** – state of mind that permits opinion without being affected by influences that compromise
  - professional judgment,
  - integrity,
  - objectivity and
  - professional skepticism.
- **Independence in appearance** – avoidance of facts & circumstances that are so significant that a reasonable & informed 3rd party, would reasonably conclude that firm's integrity, objectivity or professional skepticism had been compromised.
- Independence of auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Threats to Independence

The Code of Ethics for Professional Accountants identifies five types of threats.

(A) Self-interest threats

Occur as a result of financial or other interest in an audit client. Examples:

(i) direct financial or materially significant indirect financial interest in a client;
(ii) loan or guarantee to or from concerned client;
(iii) undue dependence on client's fees & hence, concerns about losing engagement;
(iv) close business relationship with audit client;
(v) potential employment with client; and
(vi) contingent fees for audit engagement.

(B) Self-review threats

It may occur when a previous judgment needs to be re-evaluated by professional accountant responsible for that judgment. Instances where such threats may arise:

(a) when auditor having recently been a director or senior officer of company; &
(b) when auditors perform services that are themselves subject matters of audit.

(C) Advocacy threats

- It may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised.
- For example, an auditor dealing with shares or securities of audited company, or becomes client's advocate in litigation & third-party disputes.

(D) Familiarity threats

It may occur when, because of relationship, a professional accountant becomes too sympathetic to interests of others. This can occur in many ways:

(a) close relative of audit team working in a senior position in client company;

(b) former partner of audit firm being a director or senior employee of client,

(c) long association between auditors & their specific client counterparts, &

(d) acceptance of significant gifts or hospitality from client company or directors.

(E) Intimidation threats

- It may occur when a professional accountant may be deterred from acting objectively with adequate degree of professional skepticism.
- These could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation.

Safeguards to Independence

Safeguards are actions that professional accountant takes that effectively reduce threats to comply with fundamental principles to an acceptable level.

To address the issue, the following guiding principles are to be applied:

(a) For the public to have confidence in quality of audit, it is essential that auditors should always be and appears to be independent of entities that they are auditing.

(b) Before taking on any work, auditor must conscientiously consider whether it involves threats to his independence.

(c) When such threats exist, auditor should desist from task or eliminate threat or at the very least, put in place safeguards which reduce threats to an acceptable level.

(d) If auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

(3)	**Professional Skepticism**
	Attitude that includes a questioning mind, being alert to conditions which may indicate
	possible misstatement due to error or fraud, and critical assessment of audit evidence.
	Requirement
	(1) Auditor shall plan and perform an audit with professional skepticism.
	(2) Professional skepticism includes being alter to:
	➢ Contradictory audit evidence.
	➢ Questions on reliability of documents.
	➢ Conditions indicating possible frauds.
	➢ Circumstances suggesting need for additional audit procedures.
	(3) It Reduces risk of:
	➢ Overlooking unusual circumstances.
	➢ Over generalising when drawing conclusions from audit observations.
	➢ Using inappropriate assumptions in determining NTE of audit procedures.
	(4) Professional skepticism is necessary for critical assessment of audit evidence. It
	also includes consideration of sufficiency & appropriateness of audit evidence.
	(5) Auditor cannot be expected to disregard past experience of honesty & integrity of
	entity's management and TCWG.
	Nevertheless, a belief that management & TCWG are honest and have integrity
	does not relieve auditor of need to maintain professional skepticism.
(4)	**Agreeing the Terms of Audit Engagement (SA 210)**
	Objective of Auditor
	To accept or continue an audit engagement only when the basis upon which it is to be
	performed has been agreed, through:
	(a) Establishing the existence of preconditions for an audit; and
	(b) Confirming that there is common understanding between auditor & mngt & TCWG
	of terms of audit engagement.
	Preconditions for an Audit
	Use by mngt. of an acceptable FRF in preparation of F.S. & agreement of mngt./TCWG
	to the premise on which audit is conducted.
	In order to establish whether preconditions for an audit are present, auditor shall:

(a) Determine whether FRF to be applied in preparation of F.S. is acceptable; and
[Attributes – Relevance, Completeness, Reliability, Neutrality & Understandability]

(b) Obtain agreement of mngt. that it acknowledges & understands its responsibilities:
- (i) preparation of F.S. in accordance with applicable FRF.
- (ii) exercising necessary IC to enable preparation of F.S. that are free from material misstatement, whether due to fraud or error.
- (iii) to provide the auditor with:
  - (a) Access to all relevant information such as records, documentation etc.
  - (b) Additional information that auditor may request from mngt.; and
  - (c) Unrestricted access to persons within the entity.

Auditor's action if Preconditions are not present

If preconditions are not present, auditor shall discuss matter with management and shall not accept proposed audit engagement:

(a) If he determined that FRF to be applied in preparation of F.S. is unacceptable, or

(b) If agreement of mngt. is not obtained on matters covered in pre-conditions.

Limitation on Scope Prior to Audit Engagement Acceptance

If mngt. or TCWG impose limitation on scope of auditor's work, auditor shall not accept such engagement, unless required by law or regulation to do so.

Whether any limitations imposed by Mngt.

- Yes → Do Not accept the Audit
- No → Ensure Exitance Pre-Conditions
  - Pre – Conditions Exist → Accept the audit and issue letter of Engagement
  - Pre - Conditions do not Exist → Discuss with Management and Do not accept audit in case of:
    - (a) Unacceptable FRF; or
    - (b) Mngt. does not accept their responsibilities.

Agreement on Audit Engagement Terms

(1) Auditor shall agree terms of audit engagement with management/TCWG.

(2) Agreed terms shall be recorded in an audit engagement letter.

(3) Letter of Engagement is sent by auditor to client and Includes:

- (a) Objective and scope of audit of F.S.;
- (b) Responsibilities of auditor;
- (c) Responsibilities of management;
- (d) Identification of applicable FRF for preparation of F.S.; and
- (e) Reference to expected form & content of audit reports.

Acceptance of a Change in Terms of Audit Engagement

Auditor shall not agree to a change in terms of the audit engagement where there is no reasonable justification for doing so.

Request from change Terms of Audit Engagement - Reasonable Justification Exists

- Request from entity to change terms of audit engagement may result from:
  - (a) change in circumstances affecting need for service,
  - (b) misunderstanding as to nature of audit as originally requested or
  - (c) restriction on scope of the audit engagement.
- Auditor shall consider the justification given for the request.
- Change in circumstances that affects entity's requirements or misunderstanding concerning nature of service originally requested may be considered reasonable.
- Change may not be considered reasonable if it appears that change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

Auditor consideration before agreeing to change audit engagement to engagement providing lower level of assurance

- Auditor shall determine whether there is reasonable justification for doing so.
- Before agreeing to change an audit engagement to review or related service, auditor need to assess any legal or contractual implications of change.
- If there is reasonable justification to change audit to review or related service, audit work performed to date of change may be relevant to changed engagement.

- In order to avoid confusing the reader, report on related service would not include reference to:
  - (a) Original audit engagement; or
  - (b) Any procedures that may have been performed in original audit engagement.

Auditor unable to agree to a change of the terms of the audit engagement

If auditor is unable to agree to change of terms of audit engagement & is not permitted by management to continue original audit engagement, auditor shall:

- ➢ Withdraw from audit engagement where possible under applicable L & R; &
- ➢ Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as TCWG, owners or regulators.

Recurring Audits

Assess whether circumstances require: (a) Revision of terms of audit Engagement; or (b) Reminding the existing terms.

No requirement	Requirement Exist
↓	↓
No Need to issue new Letter of Engagement	Issue New Letter of Engagement Or Record revised terms in letter of Engagement.

Circumstances in which there exist requirement of issue of New Letter of Engagement in case of Recurring Audit:

(1) Any indication that entity misunderstands objective & scope of audit.

(2) Any revised or special terms of audit engagement.

(3) Recent change of senior management.

(4) Significant change in ownership.

(5) Significant change in nature or size of the entity's business.

(6) Change in legal or regulatory requirements.

(7) Change in FRF adopted in preparation of the F.S.

(8) Change in other reporting requirements.

DO PRACTICE – Questions from Cracker (Question Bank)