

Chapter 11

Ethics and terms of engagement



ETHICS & TERMS OF AUDIT ENGAGEMENT

Q.1 PRINCIPAL APPROACH VS RULE BASED APPROACH: Refer Q-1

Principal Approach	Rule base Approach
1. Requires compliance with spirit of ethics	1. Strictly follows clearly established rules
2. Exercise professional judgement in every situation based on their professional knowledge, skill & expertise	2. It may lead to narrow outlook & spirit of ethics may be overlooked
3. Use professional judgement to evaluate every situation	3. Somewhat rigid as not possible to deal with every practical situation relying upon rules

Q.2 FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

Refer Q.2, 3, 4

Integrity	→ Requires an accountant to be straightforward & honest → It implies fair dealings & truthfulness → Not associate with reports/info which he believe to be false & misleading
Objectivity	→ Not to compromise professional judgement because of bias ← Conflict of interest → undue influence of others
Professional competence & due care	→ Attain & maintain professional knowledge & skill at the level required → Act carefully, thoroughly.



Confidentiality	→ Do not disclose info acquired during professional work unless required by law or authorised by client or employer.
Professional Behaviour	→ Comply with laws & regulations → Avoid anything that brings discredit to the profession.

Q.3 INDEPENDENCE OF AUDITORS:

A) MEANING:

- It implies that judgement of a person is
- not subordinate to
- wishes or directions
- of another person or to his own self-interest

B)

PERSPECTIVES OF INDEPENDENCE Refer Q.6

Independence of mind

- the state of mind that permits provision of opinion
- without being affected by influences
- that compromises
 - integrity,
 - objectivity &
 - professional skepticism

Independence in Appearance

- avoidance of facts & circumstances that are so significant
- that a reasonable & informed 3rd Party
- would conclude that
 - integrity
 - objectivity &
 - professional skepticismis compromised

Q.4 THREATS TO INDEPENDENCE: Refer Q.7, 8, 9, 10

SELF-INTEREST THREAT	<p>Partner/associate could benefit from financial interest in client.</p> <ol style="list-style-type: none"> 1. Direct / Indirect financial interest. (Wife \rightarrow NYKA shares ₹10L) 2. Loan/guarantee to or from client. (Axis bank $\xrightarrow{1cr}$ Loan $\xrightarrow{1cr}$ YRF) 3. Undue dependence on client's fees. (Kotak bank $\xrightarrow{3cr}$ Major client) 4. Close business relationship with client. (Disha Patni $\xrightarrow{\text{Business relation}}$ CK \rightarrow Brand Ambassador) 5. Potential employment with client (M & M $\xrightarrow[\text{CFO}]{\text{Next year}}$ 5cr + Thor) 6. Contingent audit fees. (Kingfisher $\xrightarrow{\text{Fees}}$ % of Loan obtained)
SELF- REVIEW THREAT	<ol style="list-style-type: none"> 1. Review of judgement in previous audit 2. Review of non-audit engagement (Internal audit / management services) 3. Auditor have recently been directors/senior officer of company. (2025 \rightarrow Ramesh \rightarrow Director \rightarrow 5 Star Pvt Ltd) (2026 \rightarrow Ramesh \rightarrow Auditor \rightarrow 5 Star Pvt Ltd) 4. Auditor performs services that are themselves subject matter. (Accounting & book keeping \rightarrow Ramesh \leftarrow Auditor)
Advocacy Threat	<p>People may believe that objectivity is compromised</p> <ol style="list-style-type: none"> 1. Auditor deals with shares of audited co (Lenskart \rightarrow Underwriter)



	2. Becomes clients advocate in litigation
Familiarity Threat	<p>Auditor forms relationship with client & end up being sympathetic</p> <ol style="list-style-type: none">1. Close relative of audit team → Senior position in co.2. Former partner of audit firm → Director / Senior employee of co. <p>(2025 → Ramesh → RS & Co CA Firm) (2026 → Ramesh → Director of SStar)</p> <ol style="list-style-type: none">3. Long association between client & auditor4. Acceptance of gifts/hospitality from clients
Intimidation Threat	<p>When auditor is deterred from acting objectively</p> <ol style="list-style-type: none">1. Threat of replacement2. Pressure to reduce work3. Threatened with litigation

Q.5 SAFEGUARDS TO INDEPENDENCE: Refer Q.11,12



Guiding principles to be applied



1. For public to have confidence auditor should be & appear to be independent



2. Before taking any work conscientiously consider whether there is threat to independence



3. If threat exist, desist from task or put in place safeguard



4. If auditor is unable to implement safeguard, must not accept audit engagement

Q.6 PROFESSIONAL SKEPTICISM: Refer Q.5

- Refer to an attitude that includes
- A questioning mind
- being alert
- to alert to conditions that may indicate possible misstatement due to error or fraud.

When to Apply

- C : Evidence contradicts other evidence
- R : Brings into question reliability of documents.
- A : Audit procedures in addition to those required by SA
- F : Indicate possible fraud

Benefits

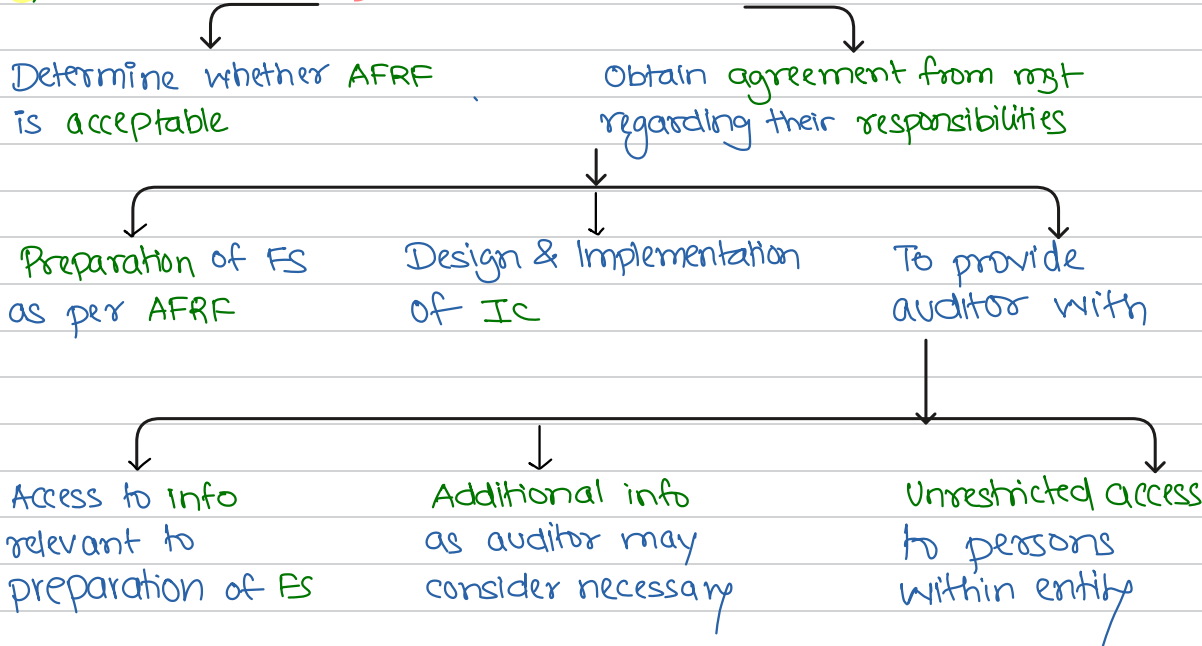
- Reduces risk of
- 1. Overlooking unusual circumstances
- 2. Overgeneralizing when drawing conclusions
- 3. Using inappropriate assumptions in determining NTE

Note: Management & TCWG is honest → does not relieve auditor to maintain skepticism



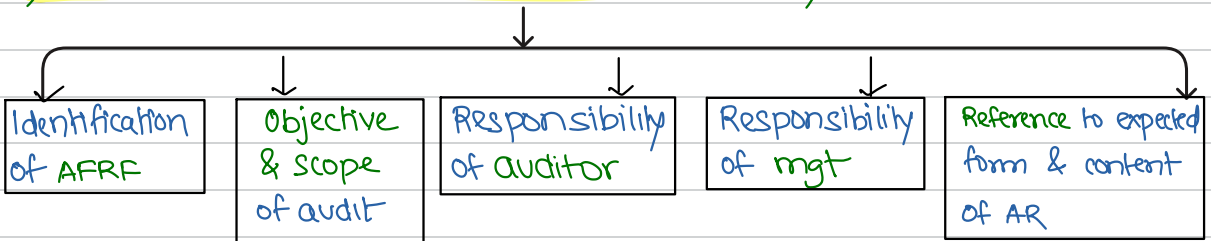
Q.7 SA 210: AGREEING TO TERMS OF AUDIT ENGAGEMENT

A) PRECONDITIONS: Refer Q.13



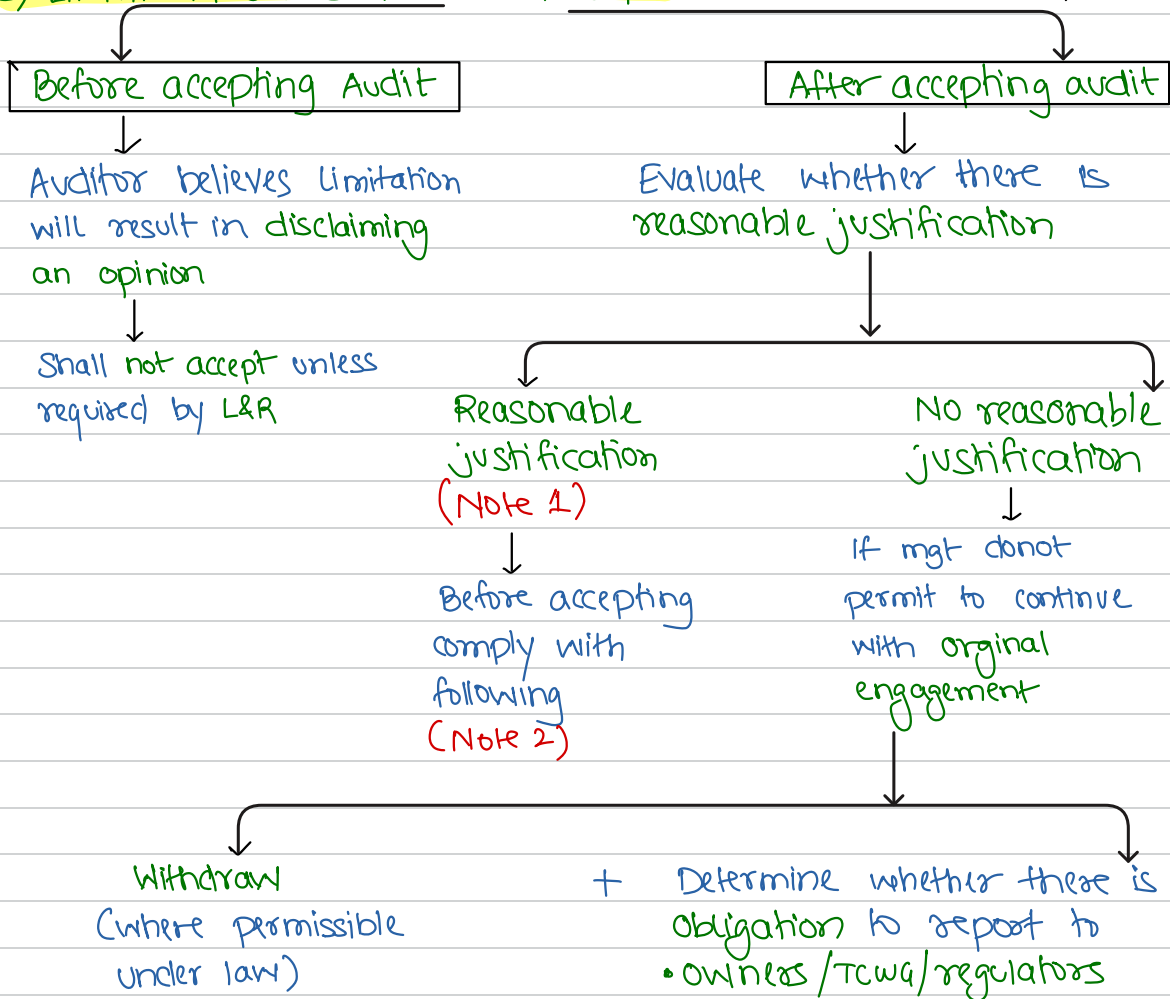
Note: If preconditions for an audit are not acceptable, auditor shall not accept unless required by law

B) CONTENTS OF ENGAGEMENT LETTER: (FORAM) Refer Q.14, 15



Note: If L&R prescribes details of terms of audit engagement, no need to record written agreement. Provided
→ L&R applies
→ Mgt acknowledges its responsibilities

C) LIMITATION ON SCOPE OF AUDIT Refer Q-16, 17, 19, 20, 21



Note 1: When reasonable justification exists?

1. Change in circumstances
2. Misunderstanding as to nature of audit
3. ROSA → Imposed by mgt or by circumstance

Reasonable: Change in circumstances / misunderstanding

Not Reasonable: change relates to info that is incorrect/incomplete/unsatisfactory



Note 2: Before accepting comply with following:

Before agreeing to change from audit → review/related service
Need to assess → Legal & contractual implication

If concludes reasonable justification → audit work performed to date of change maybe relevant

In order to avoid any confusion, report on related service would not include reference to

Original audit engagement

Any procedures performed in original audit engagement except → Agreed upon service.

D) TERMS OF ENGAGEMENT IN RECURRING AUDITS:

Factors that may make it appropriate to revise terms of engagement: (MORONS - FR)

M → Entity misunderstands objective & scope of audit

O → Significant change in ownership

R → Revised terms of engagement

O → Change in other reporting requirements

N → Change in nature & size of entity's business

S → Recent change of senior mgt

F → Change in FRF

R → Change in legal & regulatory requirement

Q.8 AUDIT QUALITY : Refer Q.22,23,24,25,26,27,28,29,30,31,32

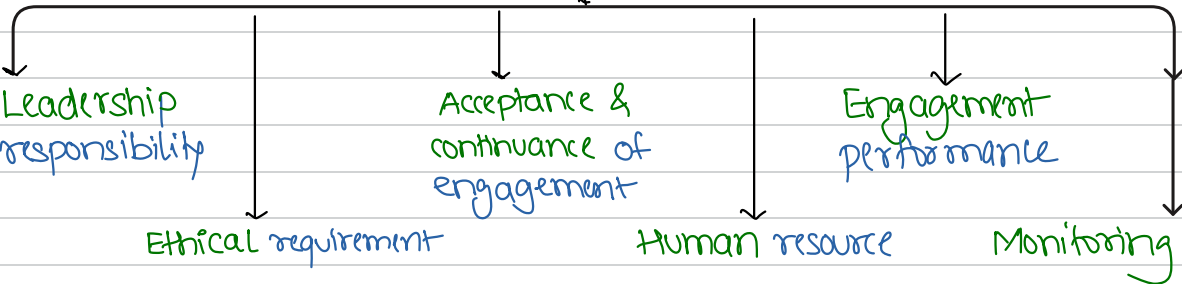
SQC-1

- Deals with quality control
- All engagements (audit/review/assurance/related service)
- Applicable to entire firm

SA-220

- Deals with quality control
- Specific to audit engagement
- Applicable to specific audit engagement

Q.9 ELEMENTS OF SYSTEM QUALITY CONTROL :



Note: 1. Quality control policies should be documented & communicated to firms personnel.

Q.10 SQC 1 VS SA 220 :

SQC-1

Leadership Responsibility

1. Firms CEO/managing partners assume ultimate responsibility
2. Persons assigned with operational responsibility by CEO/managing partner should have experience, ability & necessary authority

SA 220

Leadership Responsibility

1. Engagement partner to take responsibility
2. Communicate following to team:
 1. Perform work that complies with Std+LR
 2. Comply with firm's quality control policy
 3. Issue report that are appropriate in circum
 4. Raise concerns without fear
 5. Fact that quality is essential

Ethical Requirements:

1. Communicate independence requirements to its personnel
2. Identify & evaluate

↓
circumstances & relationships that create threats to Independence

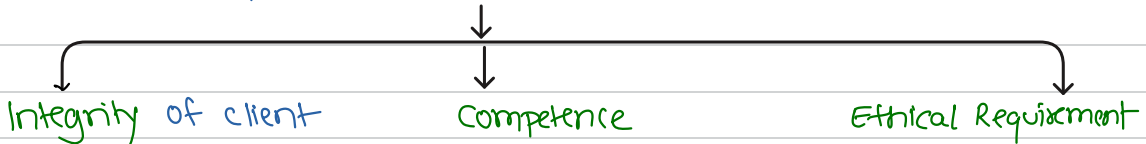
↓
Eliminate/reduce them by applying safeguards.

↓
or with draw

- Note:
1. Mechanism → EP → notify firm → threats to independence
 2. All breaches → promptly notified to firm
 3. Objective → Independence requirements are fulfilled
 4. At least annually → written confirmation → from all personnel → comply independence requirements.

Acceptance & Continuance of Client Relationship:

Before acceptance / continuance evaluate



Note 1: If there is any conflict of interest it should be resolved before accepting

Note 2: Matters to be considered for integrity of client (FIMO BAR)

F → Concerned with maintaining firm's fees low

I → Inappropriate LOSA

M → Client might be involved in money laundering

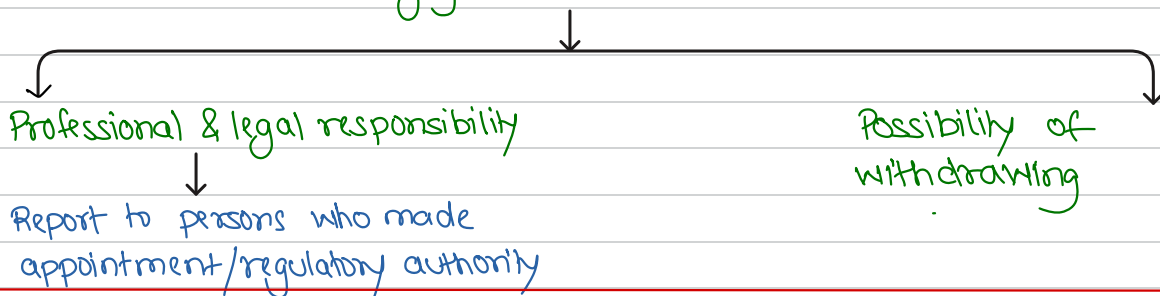
O → Nature of clients operations

B → Business reputation of client

A → Attitude of principal owner.

R → Reasons for proposed appointment & non-appointment of previous firm.

Note 3: Firm obtains info that would have caused them to decline an engagement



Human Resource:

1. Policies to ensure that firm has personnel with

- Competence
- Capabilities
- Comply with ER + SA + LR

2. HR policies should address → Recruitment

→ Compensation

→ Training

→ Career development

→ Performance evaluation



Engagement Performance:

1. Take appropriate consultations on difficult/contentious matters from
 - within team
 - within firm
 - outside firm
2. For audit of listed entity, engagement partner shall
 - a. Determine whether EQCR is appointed
 - b. Discuss significant matters with EQCR
 - c. Not date AR till completion of EQCR

Note: If difference of opinion between

- Team & those consulted or
- EP & EQCR

Follow firm's policies & procedures to resolve matter

Monitoring:

1. Monitoring process to provide reasonable assurance that firms quality control are
 - Relevant,
 - Adequate,
 - Operating effectively

2. Document the following

