

Chapter 11 – Ethics and Terms of Audit Engagements

Ethics

Concept of Ethics

- Ethics means moral principles that guide a person's behavior or actions.
- Guidelines for what is good and what is bad.
- All professions have their code of ethics

Need for Professional Ethics in Auditing

Trust in CAs	Society, government, clients, investors, and businesses trust CAs for their services.
Purpose of Ethics	<ul style="list-style-type: none"> • Ethics based on Morality important for respect/confidence • A profession gains respect when its members strictly follow ethical principles.
Responsibility of CAs	CAs have a duty to act in the public interest and maintain professional integrity.
ICAI & Ethics	CAs, whether in practice or service, must comply with code of ethics issued by ICAI
Disciplinary Actions	Violating ethical responsibilities can lead to fines, suspension, or removal from ICAI membership.

Principles Based Approach Vs Rules Based Approach

Principal Based	Rule Based
<ul style="list-style-type: none"> • Compliance with spirit of ethics • Use of Professional Judgement for arriving at conclusions • Flexible, can be applied to new situations • Can be applied across national boundaries. 	<ul style="list-style-type: none"> • Strictly follows clearly established rules. • Narrow outlook • Spirit of ethics may be overlooked • Rigid (may not deal with every situation)

Fundamental Principles of Professional Ethics

- Standard behaviour expected from Professional Accountant
- Professional accountant must comply with fundamental principles which are as follows
 1. Integrity
 2. Objectivity
 3. Professional competence and care
 4. Confidentiality
 5. Professional behaviour

Integrity

- Requires an accountant to be **straightforward** and **honest**
- Integrity implies fair dealing and truthfulness

- No association with reports etc which PA (Professional accountant) believes is
 - **Materially false** or **misleading** statement
 - **Negligently** provided
 - **Omits** required information

Objectivity

- Do **Not Compromise** Professional Judgment because of
 - **Bias, Conflict** of Interest, Undue Influence
- Do Not Accept/Continue professional activity if any circumstances/relationship influences professional accountant's judgment.

Professional Competence & Due Care

- **Attain & Maintain** Professional knowledge & skills to provide competent professional service as per
 - **Technical**/Professional standards and
 - Relevant **legislation**
- Act **diligently**
- Diligence includes responsibility to act carefully, thoroughly and on a timely basis as per requirements of an assignment.

Confidentiality

- Respect the confidentiality of information obtained during professional/business relationships
- Confidentiality serves the public interest.
- Ensure **free flow** of information from client or employing organization to the accountant, knowing it won't be disclosed to third parties.
- Confidential information may be disclosed (EXCEPTION)
 - Required by law
 - Permitted by law, Authorised by client
 - Professional duty to disclose, when not prohibited by law

Professional Behavior

- Comply with **relevant Laws** and **Regulations**
- **Avoid** conduct that might **discredit** the profession
- Don't engage in any employment (KNOWINGLY) that impairs or might impair the integrity, objectivity or reputation of profession OR does not align with the fundamental principles.

Independence of Auditor

Basics

- Independence implies that Judgment of a person should not be subordinate to the wishes or direction of another person specifically who has engaged him, or to his own self-interest.
- Independence is
 - Ability to form an opinion without being affected by any influence.
 - Ability to Act with – Integrity, Objectivity and Professional Skepticism
- Not possible to define "independence" precisely.

- Should not be confused with the superficial standards of independence or L/R
- Rules are framed with objectives, and cannot ensure the existence of independence.

Two perspectives of Independence of Auditors

Independence of Mind	Independence in Appearance
<ul style="list-style-type: none"> ● State of mind that ● Permits opinion without being affected by influences ● Acting with Integrity, Objectivity & Professional Skepticism ● A company offers an auditor a higher fee contingent on a favorable audit report. 	<ul style="list-style-type: none"> ● Avoidance of facts/circumstances ● which might lead a third party to conclude ● Integrity, Objectivity or Professional skepticism had been compromised. ● Example - If an auditor is auditing a company owned by their relative, the public might doubt their objectivity, even if the audit is fair.

Independence of the auditor has not only to exist in fact, but it should also appear to exist to all reasonable persons. Independence is a condition of mind as well as personal character

Threats to Independence 🔥

- Refer to actions, events, circumstances, or transactions that affect, hamper, impact, or hurt an auditor's independence.
- Code of Ethics for professional accountants, prepared by IFAC identifies 5 types of threats
 - Self-interest threats
 - Self-review threats
 - Advocacy threats
 - Familiarity threats
 - Intimidation threats

Threat	Meaning	Examples (Very Important)
Self Interest Threat	When an auditing firm, its partner or associate could benefit from a financial interest in an audit client.	<ul style="list-style-type: none"> ● Direct financial interest or materially significant indirect financial interest ● Loan or guarantee to/from client ● Close business relationship ● Potential employment ● Contingent fees ● Undue dependence on client's fees
Self Review Threat	Self-review threats arise when reviewing a judgment or conclusion from a prior audit or non-audit	<ul style="list-style-type: none"> ● Auditor who has recently held senior position within client organization ● Auditor provided services which will be subject to audit by him.

	engagement or if an audit team member was previously a director or senior employee of the client.	
Advocacy Threat	Promoting a client, it seems that auditor is "taking sides" of the client	<ul style="list-style-type: none"> ● Dealing in shares/securities of client ● Advocating for the co in third party disputes. ● Representing the co in litigation
Familiarity Threat	Occur when auditors forms relationships with client where they end up being TOO sympathetic to the client's interests	<ul style="list-style-type: none"> ● Close relative of audit team working in a senior position in client co ● Former partner of audit firm being a director or senior ee of the client ● Long association b/w auditors and client ● Acceptance of significant gifts/hospitality
Intimidation Threat	Client is trying to stop the auditor from acting objectively or/and you will not exercise professional skepticism.	<ul style="list-style-type: none"> ● Threat of replacement over disagreements ● Threat of litigation ● Threat of reducing work scope in proportion to reduced fees.

- Former director become Auditor : SELF REVIEW THREAT
- Former partner of firm become Director: FAMILIARITY THREAT

Safeguards to Independence

Meaning

- Actions which helps professional accountants to reduce or eliminate threats so that he can comply with fundamental principles.

Guidelines to apply Safeguards 🔥

- Confidence - Independence
 - For the public to have confidence in the quality of audit - auditors should appear independent
- Consider threats
 - Before taking any work, auditor must conscientiously consider threats to independence
- When threat exists
 - Desist from the task or
 - Eliminate the threat or

- Put Safeguards to reduce the threats to acceptable low levels.

✓ Example

- An audit partner has been auditing the same company for 10 years.
Threat: Familiarity threat – the auditor might develop a biased view.
- Action
 - Desist: The auditor resigns.
 - Eliminate: Assign a new audit partner to the engagement.
 - Apply Safeguards: Implement peer review of the audit work by another independent auditor.

- Record (Document) the safeguards. It will serve as evidence of compliance with the process.
- If auditor is unable to implement adequate safeguards → Must NOT accept the work

Holding of shares involves financial interest in the company and is in the nature of self-interest threat. A professional accountant should take steps to eliminate the threat by selling shares immediately before accepting appointment.

Professional Skepticism 🔥

Meaning

- Attitude of
 - Questioning Mind
 - Being alert to conditions
 - which may indicate possible misstatement
 - due to error or fraud, and
 - a critical assessment of audit evidence.

Examples of Professional Skepticism

Professional skepticism includes Being Alert to

- **Audit evidence**
 - Audit evidence that contradicts other audit evidence obtained.
- **Information**
 - Information that brings into question reliability of documents & responses to inquiries to be used as audit evidence.
- **Conditions**
 - Conditions that indicate possible fraud
- **Circumstances**
 - Circumstances that suggest the need for audit procedures in addition to those required by SAs

Maintaining professional skepticism

Maintaining professional skepticism throughout the audit is necessary if the auditor want to reduce the risk of

- Overlooking unusual circumstances
- Over generalising when drawing conclusions from audit observations

- Using Inappropriate Assumptions in determining NET of audit procedures & evaluating the results thereof

Professional Skepticism and Audit Evidence

- Evaluate sufficiency and appropriateness based on circumstances.
- If fraud risk exists, assess reliability of sole supporting document for material FS amount.
- Accept records as genuine unless there is reason to doubt their authenticity.
- Assess reliability of information used as audit evidence.
 - If in doubt, investigate further and modify/add audit procedures as needed.

Other Points

- Auditor may consider past experience of management's honesty
- However, trust in management does not eliminate the need for professional skepticism.

SA 210 – Agreeing the terms of Audit Engagement

Objective of the auditor

Accept or continue an audit engagement when the basis upon which it is to be performed has been agreed, through:

- Establishing whether the preconditions for an audit are present
- Confirming that there is a common understanding between the auditor and management and, where appropriate, TCWG of the terms of the audit engagement.

Establishing whether the preconditions for an audit are present

How to Establish

- whether FRF is acceptable
- Obtain the agreement of management that it acknowledges and understands its responsibility:
 - For preparation and presentation of FS as per AFRF
 - Design, Implementation and Maintenance of Internal Control for preparation and presentation of FS free from material misstatement, whether due to fraud or error
 - Provide the auditor
 - Access to all information relevant for preparation and presentation of FS
 - Additional information requested by auditor
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Preconditions Not Present

- Discuss the matter with management.
- Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement

Agreement on Audit Engagement Terms

- Auditor and client should be clear about the nature of the engagement.
- Must be in writing
- Specify the scope of the work.
- sent by the auditor to his client.
- The auditor shall agree the terms of the audit engagement with
 - management or
 - TCWG
- In the case of partnerships, a few more precautions are needed.
 - The appointment of the auditor is normally governed by the partnership deed.
 - should first get a clear idea of the nature of the service required
 - ensure that his appointment is valid.

Content of Audit Engagement Letter

The agreed terms

- shall be recorded in an audit engagement letter or other suitable form of written agreement
- shall include
 - objective and scope of the audit of the financial statements
 - responsibilities of the auditor
 - responsibilities of management
 - Identification of AFRF for the preparation and presentation of FS
 - Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
- Law or regulation prescribes in sufficient detail the terms of the audit engagement,
 - the auditor need not record them in a written agreement, except for the fact that
 - such law or regulation applies and
 - that management acknowledges and understands its responsibilities.

Limitation on Scope Prior to Audit Engagement Acceptance

- management or TCWG impose a limitation on the scope of the auditor's work
- such that the auditor believes the limitation will result in the auditor disclaiming an opinion
 - the auditor shall not accept such a limited engagement as an audit engagement,
 - unless required by law or regulation to do so.

Acceptance of a change in engagement

- Prior to completing the audit engagement,
- the auditor is requested to change the audit engagement
- to an engagement that conveys a lower level of assurance,
- the auditor shall determine whether there is reasonable justification for doing so.
 - Reasonable justification is there
 - auditor must do his work as per the new terms of engagement and must issue a report in accordance with the new terms of engagement.
 - The report would not include reference to
 - the original engagement; or
 - any procedures that may have been performed in the original engagement.
 - the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
 - No Reasonable justification
 - auditor should not agree to a change of engagement

Unable to agree to a change of the terms of the audit engagement

- If the auditor is unable to agree to a change of the terms of the audit engagement
- and is not permitted by management to continue the original audit engagement,
- Auditor shall
 - Withdraw from the audit engagement where possible under applicable law or regulation; and
 - Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as TCWG, owners or regulators.

Request from the client for the auditor to change the engagement may result from

- a change in circumstances affecting the need for the service,
- a misunderstanding as to the nature of an audit or related service originally requested.
- a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

Terms of Engagement in Recurring Audits

- The auditor may decide not to send a new audit engagement letter or other written agreement each period.
- Auditor shall assess whether circumstances require
 - the terms of the audit engagement to be revised and
 - whether there is a need to remind the entity of the existing terms of the audit engagement.
- Situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms
 - **Misunderstands** - entity misunderstands the objective and scope of the audit.
 - **Special terms** - revised or special terms of the audit engagement
 - **Senior Management** - change of senior management.
 - **Ownership** - change in ownership.
 - **Nature** - change in nature or size of the entity's business.
 - **Legal** - change in legal or regulatory requirements.
 - **Financial Reporting Framework** - change in FRF adopted in the preparation and presentation of FS
 - **Other** - change in other reporting requirements.

Audit Quality

- Purpose of audit
 - Increase the confidence of users of audited FS.
 - Therefore, quality is essential to maintain confidence in the assurance provided.
- SQC 1 and SA 220 both deal with quality control.

<u>Broad</u> - All engagements, Client relationship	<u>Narrow</u> - particular audit engagement
Get <u>support</u> from SA 220	<u>Subject</u> to SQC1

SQC1	SA 220
<u>Firm</u> level	<u>Engagement</u> level
<u>CEO</u> , MP	<u>EP</u>

SQC 1 - "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, & other Assurance and Related Services Engagements"

- Firm should **establish** a system of QC (SOQC)
- Designed to provide **reasonable assurance** wrt
 - Firm and its personnel comply with
 - Professional Standards and
 - Regulatory and legal requirements
 - Reports issued are **appropriate**

Elements of System of Quality Control MODI JI 🔥

The firm is required to create Quality control policies and procedures w.r.t following elements of SOQC.

- Leadership** responsibilities for quality within the firm
- Ethical** requirements
- Acceptance/Continuance of client **relationships** & specific engagements
- Human resources**
- Engagement **performance**
- Monitoring**

Quality control policies and procedures should be

- Documented** and
- Communicated** to the firm's personnel.
 - Firm must take **feedback** on SOQC
 - Encourages** its personnel to **communicate** their **views** or concerns on **QC** matters.

Leadership responsibilities for quality within the firm

- SQC 1 requires firms to promote an internal **culture recognizing quality** as **essential** in engagements.
- CEO** or **Managing Partner** - Hold **ultimate responsibility** for the firm's **system of quality control**
- Leaders** must set **examples** to **encourage** high quality audit work
- CEO, MP - **may assign operational** responsibility of QC to any person
 - That person should have **sufficient/appropriate experience, ability** and necessary **authority**.

Ethical Requirements

Compliance with Ethical Requirements

Firm should establish **policies** and **procedures** designed to provide with **reasonable assurance** that firm and its personnel

- Comply** with relevant **ethical requirements** as per Code of ethics issued by ICAI.
- Code establishes 5 fundamental principles of professional ethics

Independence

Independence in **all engagements** is required.

Firm should establish **policies** and **procedures** designed to provide it with **reasonable assurance** that

- Firm**, its **personnel** (including experts contracted by firm and network firm personnel)
- maintain independence** where required by Code.

Such policies and procedures should enable the firm to:

- Communicate** its independence **requirements** to its personnel
- Identify** and **Evaluate threats** to independence
- Take Action** to eliminate/reduce threats by applying safeguards, or to withdraw.

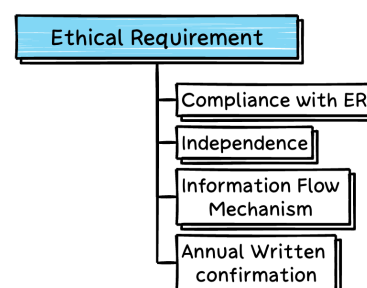
Information Flow Mechanism

- EP** can provide the **firm** with relevant **information** about client
- Personnel** can **notify threats** to independence
- All **breaches** of independence should be **promptly notified** to firm for appropriate action.

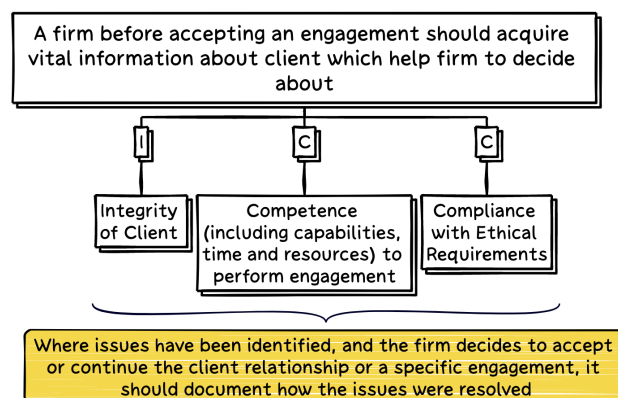
Written confirmation

Firm should obtain **annual written confirmation**

- of **compliance** with its policies and procedures
- on **independence**
- from all **relevant firm personnel**



Acceptance and Continuance of Client Relationships and Specific Engagements



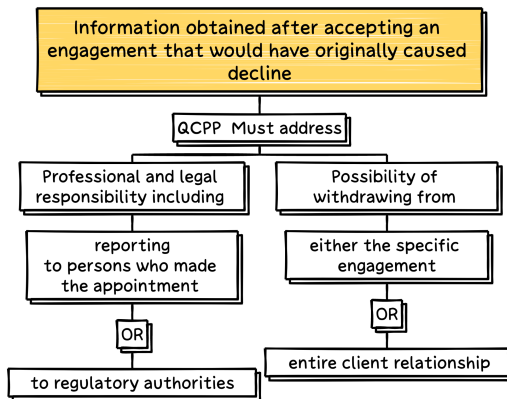
Matters to be considered with regard to INTEGRITY of the client

- Reputation** of principal owners, key MGT, related parties, TCWG
- Attitude** towards matters such as aggressive interpretation of accounting standards and IC environment.
- Nature of the **operations** and **business practices**

- Whether client is aggressively concerned with maintaining fees as **Low** as possible
 - Indication of an Inappropriate limitation in scope of work.
- **Money laundering** and **criminal activities**
- Reasons for **proposed appointment & non-reappointment** of previous firm

Other points

- A firm's **knowledge** of a client's integrity **grows** over time
- **Resolve** any **conflict** of interest **before accepting** the engagement.



Human Resources

Firm should establish policies & procedures designed to provide it with reasonable assurance that

- it has sufficient personnel with
 - Capabilities,
 - Competence, and
 - Commitment to ethical principles
- Necessary to perform engagements in accordance with
 - Professional standards and
 - Regulatory and legal requirements and
- Issue reports that are appropriate in the circumstances

Address matters such as recruitment, compensation, training, career development, performance evaluation etc.

There should be emphasis on the continuing professional development of firm's personnel

Engagement Performance

Firm should establish policies and procedures designed to provide it with reasonable assurance that

- engagements are performed in accordance with
 - professional standards and
 - regulatory and legal requirements, and
- Reports issued are appropriate

Briefing of engagement team

Engagement team must be briefed on how to achieve Consistency in Quality of Engagement Performance. Matters to be briefed.

- **Objectives** of ET
- Processes for **complying** with engagement standards
- Processes of engagement **supervision** and training
- Methods of **reviewing** performance of work
- Appropriate **documentation** of work performed

Consultation

- Appropriate consultation takes place on **difficult matters**
- With individuals **within** or **outside** the firm
- May take **advisory services** provided from other firms

Engagement Quality Control Review

Significant **judgments** made in an engagement should be **reviewed** by EQCRR (Engagement quality control reviewer) for taking an objective view **before** the **report** is issued.

The **extent** of the review depends on the

- **complexity** of the engagement and
- **risk** that the **report might not** be **appropriate** in the circumstances.

The review does **not reduce** the **responsibilities** of EP

EQCR is **mandatory** for all **listed entities**. In other engagements, firm should devise criteria to determine requirement of review

Difference of Opinion

- Between **ET** with those **consulted**
- Between **EP** and **EQCRR**
- Issue **report** only **after resolution** of such differences.
- **Recommendations** of **EQCRR** are **not accepted** by **EP** and **matter** is **not resolved** to **reviewer's satisfaction**.
 - Matter should be **resolved** by following established **procedures** of the firm like by consulting with another practitioner/firm, or professional/regulatory body.

Assembly of Final Engagement Files

Assembly of engagement files should be completed in **not more than 60 days after date** of **Audit Report** in case of **audit** engagements and in **other cases** within the **limits appropriate** to engagements

Other Points

Policies and procedures should be designed to maintain the

- **Confidentiality**
- **Safe custody**,
- **Integrity**,
- **Accessibility** and retrievability
 - of engagement **documentation**

Monitoring

Firm should ensure that policies and procedures relating to the system of QC are

- Relevant,

- Adequate,
- Operating effectively
- Complied in practice

Must include an

- Ongoing consideration & evaluation of firm's system of QC
- Periodic inspection of selected completed engagements.

SA 220-Quality Control For an Audit of Financial Statements

Objective of the auditor

To **implement QCP** at the **engagement level** that provide the auditor with **reasonable assurance** that: -

- The **audit complies** with professional standards and regulatory and legal requirements
- The auditor's **report** issued is **appropriate** in the circumstances

SA 220 is premised on the basis that the firm is subject to SQC 1

- EP is responsible for ensuring QCP as per SA 220.
- SA 220's effectiveness depends on SOQC at the firm level.
- SA 220 provides support to SQC1
 - ET must provide NECESSARY information to support firm's quality control, specifically regarding independence

SA 220 is based on the assumption that the **audit firm follows SQC 1** (firm-wide quality control standards)

Engagement Partner's Responsibilities under SA 220 🔥

It describes responsibilities of EP in relation to following matters

- Leadership responsibilities for quality on audits
- Relevant ethical requirements
- Acceptance and continuance of client relationships and audit engagements
- Assignment of engagement teams
- Engagement performance
- Monitoring

Leadership responsibilities for quality of audits 🔥

EP must take responsibility for overall quality of audit engagement.

His action and message should emphasise -

- Importance to audit quality of (Factors crucial for maintaining audit quality.) (Audit quality ke Liye in factors ki kya importance hai aur audit quality ke Liye kaunse factors sabse jyada important hai)
 - **Work** that **complies** with professional standards and regulatory and legal requirements;
 - **Complying** with the **firm's SOQC** policies and procedures
 - **Reports** are **appropriate** in the circumstances
 - ET's **ability** to **raise concerns** without fear of **reprisals**.
- Fact that **quality** is **essential** in performing audit engagements.

Relevant Ethical Requirement

EP's responsibilities are as under

- Identifying threats to independence.
 - That safeguards may not be able to eliminate or reduce to an acceptable level. (Financial Interest - If the auditor owns shares in the client company, even safeguards like disclosure cannot eliminate the conflict.)
- Reporting by EP
 - to relevant persons in firm
 - to determine appropriate action, which may include
 - Eliminate the threat

- Withdrawing from the audit engagement

Acceptance and Continuance of Client Relationships and Audit Engagements

Responsibilities of EP

- Obtain such **information** as he considers necessary in the circumstances
 - before **accepting** an engagement with a new client,
 - when deciding whether to **continue** an existing engagement, and
 - when considering **acceptance** of a **new** engagement with an **existing client**
- Information on
 - **Integrity** of principal owners
 - **Competence** of ET
 - **Compliance** with relevant ethical requirements

Significant **matters** from **current/previous audits Assist EP** in **assessing** acceptance and continuance of client and audit engagements

Assignment of engagement teams

EP should **ensure**

- **ET** and auditor's **experts** have **necessary**
 - **competence** and **capabilities** to perform engagement
 - as per professional standards & regulatory and legal requirements.

Engagement Performance

EP is responsible for -

- **Conduct** of an **audit** as per
 - professional standards and
 - regulatory and legal requirements
- **Issue** of **Report** appropriate in circumstances
- **Review** of **audit documentation** before issue of audit report
- Ensuring sufficient appropriate audit evidence supports conclusions.
- Responsible for **consultation** on difficult matters within or outside team

Responsibilities of EP for engagement quality control review

For listed entities, and for entities for which the firm has determined that an engagement quality control review is required, EP shall:

- Determine **EQCRR** has been **appointed**
- **Discuss significant matters** with EQCRR
- **Not date** the **auditor's report** until completion of engagement quality control review.

Differences of opinion

- Within ET, with those consulted
- Between EP and EQCRR

- Follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

- Effective monitoring process designed to provide firm with reasonable assurance that its policies & procedures relating to system of QC are
 - Relevant
 - Adequate, and
 - Operating effectively
- EP shall consider
 - latest information circulated by firm or network firms (Latest monitoring results)
 - whether deficiencies noted in that information may affect audit engagement.

EP should document following matters pertaining to audit engagement

(Compliance, Independence, Acceptance/Continuance consultation)

- Issues identified wrt compliance with ethical requirements and how they were resolved.
- Conclusions on
 - Compliance with independence requirements and
 - Discussions supporting these conclusions.
- Conclusions on client acceptance and continuance.
- Nature and scope of, and conclusions resulting from consultations undertaken

Short Forms

EP	Engagement Partner
ET	Engagement Team
EQCRR	Engagement Quality Control Reviewer
QC	Quality Control
SOQC	System of Quality Control
QCP	Quality Control Procedures
SAAE	Sufficient Appropriate Audit Evidence