

# *CA INTER* **AUDIT** *NOTES*

For May **2024** & Onwards



BY  
CA SHUBHAM  
KESWANI

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### What's Financial Audit?

- Audit is an **independent examination**
- of **financial information**
- of any **entity**, whether profit oriented or not, and irrespective of size or legal form,
- when such an examination is conducted with a view to **expressing an opinion** thereon.

Objectives of auditor as per SA-200 "Overall Objectives of Independent Auditor and Conduct of Audit in accordance with Standards on Auditing" are:

In conducting an audit of F.S., overall objectives of the auditor are:

- (a) To **obtain Reasonable Assurance** about whether F.S. as a whole
- are **free from material misstatement**, whether due to fraud or error,
  - enabling auditor to express an **opinion**
  - on whether F.S. are **prepared**, in all *material respects*,
  - as per **applicable FRF** and
- (b) To **report on FS** and **communicate** as per SAs, as per auditor's findings.

#### Reasonable Assurance

- In context of audit of F.S, a **HIGH, but not absolute**, level of assurance.
- To obtain **reasonable assurance** → auditor shall **obtain SAAE** to **reduce audit risk to an acceptably low level** and draw reasonable **conclusions** on which to base auditor's **opinion**.

#### Financial statements(F.S.)

##### Structured representation of

- **historical financial info.**, including related **notes**, to communicate
- entity's **economic resources or obligations** at a point in time or
- **changes** therein for a **period of time** as per FRF.

"Historical financial info" means info. expressed in **financial terms**

- of particular entity,
- derived from **entity's accounting system**,
- about **economic events** occurring in past time periods or
- about **economic conditions or circumstances** at points in time in the past.

Applicable financial reporting framework (FRF) - FRF **adopted** by mgt and, where appropriate, TCWG in preparation and presentation of F.S. that's **acceptable** in view of nature of entity and objective of F.S., or is required by law or regulation.

## Ch-1 Intro to Auditing

### Misstatement

#### Difference

- b/w amount, classification, presentation, or disclosure (A/C/P/D) of reported F.S. item &
- A/C/P/D required as per applicable FRF. **Can arise from error / fraud.**

Those charged with governance (TCWG) - Person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for **overseeing the strategic direction** of entity and obligations related to the **accountability** of entity. (Executive Members-CEO/CFO/MD)

#### Audit- Mandatory OR Voluntary?

- Not mandatory for all.
- **Companies compulsorily** required to get accounts audited under law.
- Non-corporate entities **may get audit** of accounts **under tax laws**. For eg, in India, accounts audited if t/o crosses threshold limit under income tax law.
- Some entities like schools may be required to get their accounts audited for purpose of obtaining grant or assistance from Govt. Audit is **not always mandatory**.
- Many entities may get accounts audited voluntarily because of benefits from audit.

#### Who appoints Auditor?

Auditor is appointed by **owners or in some cases by constitutional or govt authorities** as per applicable laws and regulations.

For eg,

- ✓ Companies → Appointed by members (shareholders) in AGM.
- ✓ Govt companies → Comptroller and Auditor General of India (CAG),
- ✓ Firm → partners of firm.

#### To whom Report is Submitted by Auditor?

Report is submitted to **person making the appointment**.

- Companies → shareholders
- Firm → partners

#### Benefits of Audit-Why audit is needed?

- Point out deficiencies: Audit **reviews** existence and operations of various **controls** operating in entity. Hence, it's useful at pointing out deficiencies.
- Detection: Audit may also detect **fraud or error** or both.
- Moral Check on Employees: Audit acts as moral check on employees **from committing frauds** for fear of being discovered by audit.



## Ch-1 Intro to Auditing



- High Quality: Audited accounts provide **high quality information**. Gives **confidence to users** that info on which they are relying is qualitative & outcome of exercise carried out by following Auditing Standards.
- Safeguarding Shareholder's Interest: In case of companies, shareholders may/may not be involved in the daily affairs. FS are prepared by mgt consisting of directors. As shareholders are owners of Co, they **need an independent mechanism** so that financial info is qualitative and reliable. Hence, their interest is safeguarded by audit.
- Help to Govt: Audited FS are helpful to govt authorities for **determining tax liabilities**.
- Creditors/lenders: Audited FS can be relied upon by lenders, bankers for **making their credit decisions** i.e. whether to lend or not to lend to a particular entity.

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### How Auditor ensures F.S. don't mislead anybody?

This he can do honestly by satisfying himself that: [MTP-Oct'21]

- i) accounts have been drawn up with **reference to entries in books of a/c**
- ii) **entries** in books of a/c are adequately **supported by sufficient and appropriate evidence**
- iii) **none of the entries** in books of a/c has been **omitted** in process of compilation and nothing which is not in books of a/c has found place in the statements
- iv) **information** conveyed by the statements is **clear and unambiguous**
- v) F.S amounts are properly classified, described and disclosed **in conformity with a/c std**
- vi) statement of a/c present **true and fair picture** of operational results & assets & liabilities

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Note: Auditing provides assurance. Providing confidence to users of FS. Lends credibility to FS. Confidence to users that financial info. reflected in FS can be relied upon.

## Inherent Limitations of Audit [ILA]

Auditor is not expected to, and **can't, reduce audit risk to zero** and cannot therefore obtain absolute assurance that F.S. are free from M.M. due to fraud or error.

This is because there are ILA.

The inherent limitations of an audit arise from:

(i) Nature of Financial Reporting:

- ✓ Preparation of F.S. involves **judgment by mgt.**
- ✓ These judgments may involve **subjective decisions** or a degree of **uncertainty.**
- ✓ **Internal Controls** may not operate to provide reliable financial info. due to their own limitations.

(ii) The Nature of Audit Procedures: [RTP Nov-21/22]

There are practical and legal limitations on auditor's ability to obtain audit evidence. For eg:

Auditor **doesn't test all** transactions and balances. He forms his opinion only by testing samples. It's an eg. of practical limitation on auditor's ability to obtain audit evidence.

**Mgt may not provide complete info.** as requested by auditor. No way by which auditor can force mgt to provide complete info. as may be requested by auditor. In case he isn't provided with info, he **can only report.** It is eg of **legal limitation** on auditor's ability to obtain audit evidence.

Mgt may consist of **dishonest and unscrupulous people** and may be involved in **fraud.** It may be engaged in **concealing fraud** by designing **sophisticated and carefully organized schemes** hard to detect by auditor.

Examples:

- ⇒ It may produce **fabricated documents** to make him believe that audit evidence is valid. However, in reality, fake or non-genuine.
- ⇒ Entity may enter into **transactions with related parties.** Such transactions may be **only paper transactions & not actually** occurred. Auditor may not be aware of such related party relationships or audit procedures may be unable to detect probable wrong doings in such transactions.

(iii) Not in nature of investigation.

- ✓ Audit is **not official investigation into alleged wrong doing.**
- ✓ He **doesn't have specific legal powers** of search or recording statements of witness on oath which may be necessary for carrying out official investigation.
- ✓ Audit is **distinct** from investigation.
- ✓ **Investigation** is a **critical examination** of accounts with a **special purpose.** For eg, if fraud is suspected and it's specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.



- ✓ **Objective of audit**, on other hand, is to **obtain reasonable assurance** about whether FS as whole are free from material misstatement, whether due to fraud/error, enabling auditor to express an opinion.

(iv) **Timeliness of Financial Reporting and Balance between Benefit and Cost:**

Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between reliability of information and its cost.

Eg. Auditor conducting audit of since last 2 years. During these 2 years, he has sought detailed info. from mgt regarding various matters. During 3<sup>rd</sup> year, he chooses to rely upon some info. obtained in 2<sup>nd</sup> year audit. It could be possible that something new has happened and that info. isn't relevant. So, information being relied upon by auditor is not timely and may have lost its reliability.

(v) **Future events**

- Future events or conditions **may affect an entity adversely**. Adverse events may seriously affect ability of entity to continue its business.
- **Business may cease** to exist in future due to **change in market conditions, emergence of new business models** or products or due to onset of some adverse events.

Therefore auditor **can't provide guarantee** that FS are free from MM due to frauds/errors

Whether auditor has performed an audit as per SAs is determined by

- **audit procedures** performed in the circumstances,
- sufficiency & appropriateness of **audit evidence** obtained and
- **suitability of audit report** based on evaluation of evidence in light of overall objectives of auditor.

**Professional Skepticism [RTP Nov-22]**

Professional skepticism refers to an **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.

Auditor shall plan & perform audit with professional skepticism recognising that circumstances may exist that cause FS to be materially misstated.

Professional skepticism includes being alert to, for example:

- Audit evidence that **contradicts** other audit evidence obtained.
- Info. that brings into **question reliability of documents** & responses to inquiries to be used as audit evidence.



## Ch-1 Intro to Auditing

- Conditions that may indicate **possible fraud**.
- Circumstances that suggest **need for audit procedures in addition** to those required by SAs.

Maintaining professional skepticism throughout audit for auditor to reduce risks of:

- **Overlooking** unusual circumstances.
- **Over-generalising** when drawing conclusions from audit observations.
- **Using Inappropriate assumptions** in determining nature, timing, and extent of audit procedures and evaluating the results thereof.

### Notes:

- ✓ It also includes **consideration of sufficiency and appropriateness of audit evidence** obtained in light of circumstances, for eg in case **where fraud risk factors exist** and a **single document**, of a nature **susceptible to fraud**, is sole supporting evidence for a material F.S. amount.
- ✓ Auditor may accept records and documents as **genuine unless reason** to believe contrary.
- ✓ Auditor is required to **consider reliability of information** to be used as audit evidence.
- ✓ In cases of doubt or indications of possible fraud, SAs require auditor to **investigate further** & determine **modifications or additions** to audit procedures are necessary to resolve the matter.
- ✓ Auditor **can't disregard past experience** of honesty and integrity of entity's mgt and TCWG.
- ✓ Nevertheless, a belief that mgt and TCWG are honest and have integrity **doesn't relieve auditor of need to maintain professional skepticism**.

### What's an Engagement?

An arrangement to do something.

Auditing → Formal agreement b/w auditor & client under which auditor agrees to provide auditing services. It takes the shape of engagement letter [SA 210]

### Assurance Engagement

Engagement in which

- practitioner expresses a **conclusion**
- to enhance degree of **confidence**
- of **intended users** other than responsible party
- about **outcome of evaluation** or measurement of
- a **subject matter against criteria**.

Practitioner **gives opinion** about specific info due to which users are able to make **confident decisions** that chance of info. being incorrect is diminished.



## Elements of an Assurance Engagement

### Parties

3 party relationship involving a **practitioner**, a **responsible party**, and **intended users**

1. Practitioner is a person **who provides the assurance**. Term practitioner is **broader than auditor**. Audit is related to historical info, whereas practitioner may provide assurance **not necessarily related to historical financial info**.
2. Responsible party is the party responsible for **preparation of subject matter**.
3. Intended users are persons **for whom assurance report is prepared**. These persons may use report in making decisions.

### Subject matter

It refers to **info. to be examined by practitioner**. For eg, financial info. contained in FS while conducting audit of FS.

### Suitable criteria

Refer to **benchmarks** used to **evaluate the subject matter** like standards, guidance, laws, rules and regulations.

### Sufficient appropriate evidence [SAAE]

- ✓ Practitioner performs an assurance engagement to obtain SAAE.
- ✓ It is on basis of evidence that conclusions are arrived and opinion is formed by auditor.
- ✓ **"Sufficient" relates to quantity** of evidence obtained by auditor.
- ✓ **"Appropriate" relates to quality** of evidence obtained by auditor. One evidence may be providing more comfort to auditor than other evidence.
- ✓ Evidence should be both sufficient and appropriate.

### Written assurance report in appropriate form

Written report is provided **containing conclusion** that conveys assurance about subject matter.

A written assurance report is outcome of an assurance engg.

## Audit Vs. Review

- ✓ Audit is a **reasonable assurance engg**.
- ✓ Review is a **limited assurance engg**. It provides **lower level of assurance than audit** i.e. Moderate assurance.
- ✓ Further, review involves **fewer procedures** and gathers **sufficient appropriate evidence** on basis of which **limited conclusions** can be drawn up.
- ✓ However, both "audit" and "review" are related to FS prepared on basis of historical financial info.



Reasonable assurance engagement	Limited assurance engagement
High level of assurance.	Lower level of assurance than reasonable assurance engg.
Elaborate & extensive procedures to obtain SAAE.	Fewer procedures as compared to reasonable assurance engg.
It draws reasonable conclusions on basis of SAAE.	It involves obtaining SAAE to draw limited conclusions.
Eg. of reasonable assurance engg is audit engg.	Eg of limited assurance engg is review engg.

Prospective financial info. means financial info. based on assumptions about events that may occur in future and possible actions by entity. Can be in form of a forecast or projection or combination of both.

- In assurance reports involving PFI, practitioner obtains SAAE to effect that mgt's assumptions on which PFI is based are not unreasonable, PFI is properly prepared on basis of assumptions & it's properly presented and all material assumptions adequately disclosed.
- PFI relates to future events. While evidence may be available to support assumptions on which PFI is based, such evidence is itself generally future- oriented.
- Auditor is not in a position to express an opinion as to whether results shown in PFI will be achieved. Therefore practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions don't provide a reasonable basis for projection.
- Hence, such type of assurance engagement provides only a "moderate" level of assurance.

#### Examples of assurance engagements

Example of assurance engagement	Type of assurance engagement
Audit of FS	Reasonable assurance engg.
Review of FS	Limited assurance engg.
Examination of PFI	Provides assurance regarding reasonability of assumptions forming basis of projections.
Report on controls operating at organisation.	Provides assurance regarding design and operation of controls

#### Engagement & Quality Control Standards

Following Standards are collectively known as Engagement Standards: -

1. Standards on auditing (SAs) which apply in audit of historical financial info.
2. Standards on review engagements (SREs) which apply in review of historical financial info.
3. Standards on Assurance engagements (SAEs) which apply in assurance engg. other than audits and review of historical financial info.



4. Standards on Related Services (SRSs) which apply in agreed upon procedures to info, compilation engg. and other related service engagements.

Purpose of these standards is to establish high quality standards & guidance in areas of FS audits and other types of assurance services.

#### Why are Standards needed?

- Standards ensure carrying out of audit against established benchmarks at par with global practices.
- Standards improve quality of financial reporting helping users to make diligent decisions.
- Standards ensure audit quality.
- Standards promote uniformity as audit of FS is carried out following these Standards.
- Standards equip professional accountants with professional knowledge and skill.

#### Duties in relation to Engagement and Quality Control Standards

- Duty of professional accountants follow the Standards in engagements.
- Situation may arise when specific procedure required in Standards would be ineffective.
- In such case, document how alternative procedures performed to achieve required purpose.
- Also, reason for departure to be documented unless it's clear.
- Further, report should draw attention to such departures.
- Mere disclosure in report doesn't absolve professional accountant from complying with applicable Standards.

#### Interdisciplinary Nature of Audit - Relation with diverse subjects

- Auditing and Accounting: Auditing reviews FS which are nothing but a result of overall accounting process.
- Auditing and Law: Auditor should have a good knowledge of business laws affecting the entity.
- Auditing and Economics: Auditor is expected to be familiar with overall economic environment of client. Auditing and Behavioural Science: Knowledge of human behaviour is essential for auditor to effectively discharge his duties.
- Auditing and Statistics & Mathematics: Also expected to have knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.
- Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.
- Auditing and Financial Management : Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.
- Auditing and Production: Good auditor is one who understands client and his business functions such as production, cost system, marketing etc.



### Qualities of Auditor

- Auditor is concerned with reporting on financial matters of business and other institutions. Financial matters are set with problems of **human fallibility**; **errors and frauds** are frequent.
- Tact, caution, firmness, good temper, integrity, etc are some qualities which auditor should have.
- In short, all **personal qualities** that make a **good businessman** contribute to making of a **good auditor**.
- In addition, he must have **shine of culture** for attaining a great height.
- He must have highest degree of **integrity** backed by adequate **independence**.
- Auditor, holds a position of **trust**, must have **basic human qualities** apart from technical requirement of professional training and education.
- He **critically reviews FS** and useless for him to attempt that task unless he has **expert knowledge**.
- **Exhaustive knowledge of accounting** is must for auditor. **Must know all a/c principles and techniques**.

*"Harder you work, the BETTER you get"*

## SA 210: Agreeing the Terms of Audit Engagement

Objective of auditor is to accept or continue an audit engg. **only when basis** upon which it is to be performed has been **agreed**, through:

- A. Establishing whether **preconditions for audit are present** and
- B. Confirming that there is a **common understanding b/w auditor and mgt** and, where appropriate, TCWG of terms of the audit engg.

## Preconditions for Audit [RTP May-21]

In order to establish whether preconditions for audit are present, auditor shall:

- (a) Determine whether **FRF is acceptable**; and
- (b) Obtain **agreement of mgt** that it **acknowledges and understands** its responsibility:
  - (i) For **preparation of F.S.** as per applicable **FRF**
  - (ii) For **internal control** as mgt considers necessary and
  - (iii) To **provide auditor with**:
    - ✓ **Access to all information** such as records, documentation and other matters
    - ✓ **Additional information** that auditor may request from mgt for audit &
    - ✓ **Unrestricted access** to persons within entity from whom auditor determines it necessary to obtain audit evidence.

## What if Pre-conditions not Present?

If preconditions for audit not present, **discuss the matter with mgt**.

Unless required by L/R, auditor shall **not accept proposed audit engg**: -

- a) If auditor has determined that **FRF** to be applied in preparation of FS is **unacceptable** or
- b) If **agreement of mgt is not obtained** on matters relating to **understanding of responsibility** of preparation of FS, **internal controls** for preparation of FS, **providing access to all info.** and **unrestricted access to persons within entity**.

## Contents of Engagement Letter [May-17]

Agreed terms of audit engg shall be recorded in an audit engg. letter or other suitable form of **written agreement**. **EL is sent by auditor to his client**.

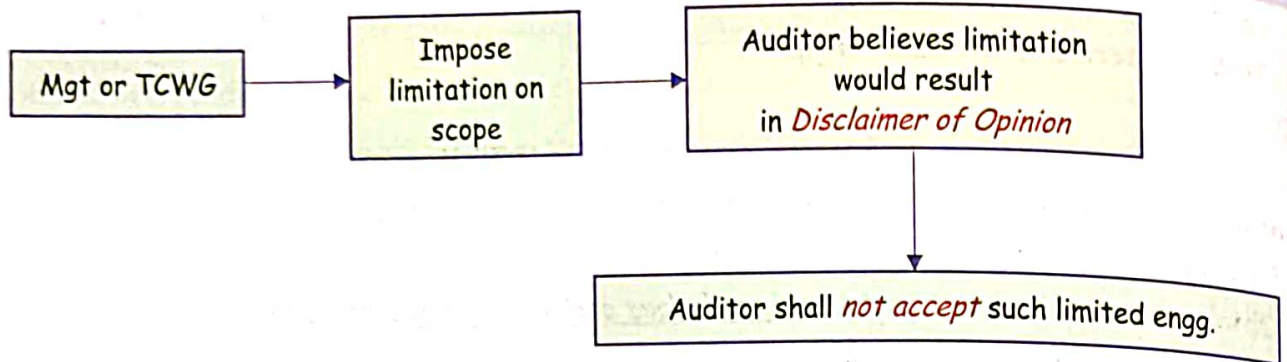
It shall include:

- a) **Objective and scope of audit of FS**
- b) **Responsibilities of the auditor**
- c) **Responsibilities of management**
- d) Identification of **applicable FRF** for preparation of FS and
- e) Reference to **expected form and content of reports to be issued by auditor** & a statement that there may be circumstances in which report may differ from its expected form and content.



If law or regulation prescribes in sufficient detail terms of audit engg, auditor need not record them in written agreement, except for fact that such law or regulation applies and mgt acknowledges & understands its responsibilities.

### Limitation on Scope Prior to Audit Engagement Acceptance



### Acceptance of Change in Terms of Audit Engg.

Auditor shall not agree to change in terms of audit engg where there's no reasonable justification.

Request from Entity to change Terms of Audit Engg-When Reasonable Justification Exists?

Request from entity for auditor to change terms of audit engg may result from

- ✓ change in circumstances affecting need for service,
- ✓ misunderstanding as to nature of an audit as originally requested or
- ✓ restriction on scope of audit engg, whether imposed by mgt or caused by other circumstances.

Auditor considers justification given, particularly implications of a restriction on scope of audit engg.

Change in circumstances that affect entity's requirements or misunderstanding concerning nature of service originally requested may be considered a reasonable basis for requesting a change in audit engg.

In contrast, a change may not be considered reasonable if it appears that change relates to information that's incorrect, incomplete or otherwise unsatisfactory. An eg. might be where auditor unable to obtain SAAE regarding receivables & entity asks for audit to be changed to review engagement to avoid a qualified opinion or a disclaimer of opinion.

What should auditor consider before agreeing to change audit engg to engg. providing lower level of assurance?

If, prior to completing audit engg, auditor is requested to change audit engg. to an engg. that conveys lower level of assurance, determine whether there is reasonable justification for doing so.

Before agreeing to change an audit engg. to a review or a related service, auditor who was engaged to perform audit as per SAs may also need to **assess legal or contractual implications of change.**

If auditor **concludes there's reasonable justification** to change audit engg. to a review or a related service, **audit work performed till date of change may be relevant** to changed engagement.

However, **work required to be performed and report to be issued would be those appropriate to the revised engg.**

In order to **avoid confusing reader**, report on related service would not include reference to:

(a) **Original audit engg** or

(b) **Any procedures that may have been performed in original audit engg,**

No reference to original

**except where audit engagement is changed to engg. to undertake agreed-upon procedures and thus reference to procedures performed is a normal part of report.**

If terms of audit engg are changed, auditor and mgt shall agree and record new terms of engg. in an engg letter or other suitable form of written agreement.

**Recurring Audit Engagements → New Engg Letter? [RTP May-21]**

Auditor shall assess whether circumstances require terms of audit engg. to be revised and whether there is a need to remind entity of existing terms of audit engg. Auditor may decide not to send new audit engg letter.

Following factors may make it appropriate to revise terms of audit engg. or remind entity of existing terms:

- ✓ Any indication that **entity misunderstands** objective and scope of audit.
- ✓ Any **revised or special terms** of audit engagement.
- ✓ A **recent change of senior management.**
- ✓ A significant change in **ownership.**
- ✓ A significant change in **nature or size of the entity's business.**
- ✓ A change in **legal or regulatory requirements.**
- ✓ A change in **FRF** adopted in preparation of F.S.
- ✓ A change in **other reporting requirements.**



## SQC-1 & SA 220 "Quality Control for an Audit of Financial Statements"

### Elements of a System of Quality Control

Firm's system of quality control should include policies and procedures addressing each of following elements:

- (a) **Leadership** responsibilities for quality within the firm.
- (b) **Ethical** requirements.
- (c) **Acceptance** and continuance of client relationships and specific engg.
- (d) **Human** resources.
- (e) **Engagement** performance.
- (f) **Monitoring**.



### Leadership Responsibilities for Quality on Audits

**Engagement partner (EP)** shall take responsibility for overall quality on each audit engg to which that partner is assigned.

Actions of EP and appropriate msgs to other members of engg team, in taking responsibility for overall quality on each audit engagement, emphasise:

- (a) The **importance to audit quality** of:
  - i) Performing work that **complies** with **Professional stds, Regulatory and Legal requirements (PRL)**
  - ii) Complying with **firm's quality control policies and procedures** as applicable
  - iii) Issuing **auditor's reports that are appropriate** in the circumstances and
  - iv) The engagement team's ability to **raise concerns without fear** of reprisals and
- (b) Fact that **quality is essential** in performing audit engg.

Engagement partner (EP) refers to partner or other person in firm who is **responsible** for audit engagement and its performance, and for auditor's report that is issued on behalf of firm, and has **appropriate authority** from a professional, legal or regulatory body.

### Ethical Requirements

#### Fundamental principles of professional ethics

##### (a) Integrity

- Requires auditor to be **straight forward and honest** in all professional & business relationships.
- Implies **fair dealing and truthfulness**.
- It effectively means that he shall **not be associated with reports, returns, communications or other info** which he believes contains a
  - **materially false** or **misleading** statement
  - contains statements or info. **provided recklessly** or

- **omits** required info. where such omission could be misleading.

(b) Objectivity

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

(c) Professional competence and due care

Requires auditor to **attain and maintain professional knowledge and skill** at the level required to render competent professional service and also to **act diligently** and as per technical & professional **standards**.

(d) Confidentiality: Requires auditor to **respect confidentiality** of info. acquired as result of professional or business relationships.

(e) Professional behaviour

It requires an auditor to **comply with relevant laws and regulations** and **avoid any conduct** that he knows or should know **might discredit the profession**.

Auditor should be Independent of the entity subject to Audit.

Independence comprise of both: **Independence of Mind & Independence in Appearance**.

1. Independence of mind - state of mind that permits provision of opinion **without being affected by influences** allowing individual to act with integrity, exercise objectivity and professional skepticism
2. Independence in appearance - avoidance of facts and circumstances that are so significant that a **3<sup>rd</sup> party would reasonably conclude** an auditor's integrity, objectivity or professional skepticism had been compromised.

It enhances auditor's ability to act with integrity, be objective and maintain attitude of professional skepticism.

### Types of Threats to Independence

5 types of threats:

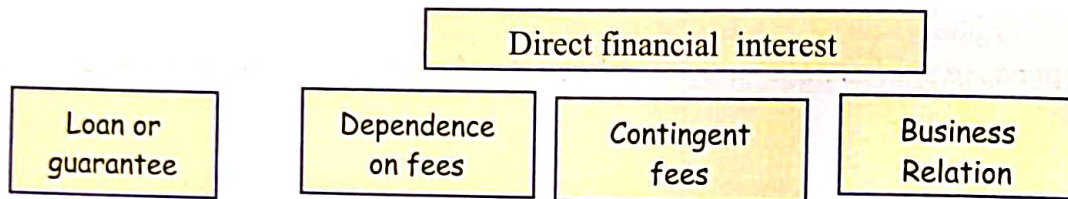
1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a **financial interest** in an audit client.

Examples include:

- i) **direct financial interest** or materially significant indirect financial interest in a client,
- ii) **loan or guarantee** to or from the concerned client,
- iii) **undue dependence on a client's fees** and, hence, concerns about losing engg,
- iv) **close business relationship** with an audit client,

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- v) **potential employment** with the client, and
- vi) **contingent fees** for audit engagement.



2. Self-review threats, which occur when during a **review of judgement or conclusion** reached in a previous audit or non-audit engg or when **audit team member was previously director or senior employee** of client.

(**Non-audit services** include any professional services provided, other than audit or review of FS. These include mgt services, internal audit, investment advisory service, design and implementation of IT systems etc.),



Instances where such threats come into play are:

- i) when an auditor having **recently been a director or senior officer** of company, and
- ii) when auditors perform **services that are subject matters of audit**.

3. Advocacy threats, which occur when auditor **promotes, or is perceived to promote, a client's opinion to a point** where people may believe that **objectivity is getting compromised**.

Examples:

Auditor dealing in shares or securities of Co.

Auditor becomes advocate in litigation or 3<sup>rd</sup> party disputes

4. Familiarity threats occur when auditors **form relationships** with client end up being **too sympathetic** to client's interests.

This can occur in many ways:

- i) **close relative** of audit team working in a senior position in client company
- ii) **former partner** of audit firm being a director/senior employee of client
- iii) **long association** b/w auditors and client counterparts and
- iv) acceptance of **significant gifts or hospitality** from client, its directors or employees.

5. Intimidation threats, which occur when auditors are **deterred from acting objectively** with an adequate degree of professional skepticism.

Basically, these could happen because of

- o **threat** of replacement over disagreements with application of a/c principles or
- o **pressure** to disproportionately reduce work in response to reduced audit fees or

- o being threatened with litigation.

### Safeguards to Independence

Following are the guiding principles in this regard: -

1. For public to have confidence in quality of audit, essential that auditors should **always be and appears to be independent** of entities they are auditing.
2. In case of audit, **key fundamental principles** are **integrity, objectivity and professional skepticism**, which require auditor to be independent.
3. **Before taking any work**, auditor must consider whether it **involves threats** to his independence.
4. When **threats exist**, auditor should **desist from task** or put in place safeguards that **eliminate them**.
5. If auditor unable to implement safeguards, must **not accept the work**.

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### Independence

Policies and procedures should enable firm to: -

(a) **Communicate its independence requirements** to its personnel

(b) Identify and evaluate

- ⇒ **circumstances and relationships** that create **threats** to independence,
- ⇒ Obtain info on **identified breaches**, if any, of firm's P&P, check if they create threat and
- ⇒ to take appropriate **action**
  - ✓ to **eliminate** those threats or
  - ✓ **reduce** them to an acceptable level by applying safeguards, or,
  - ✓ if considered appropriate, to **withdraw** from the engagement.

EPs provide firm with relevant info about client and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence.

**All breaches** of independence should be **promptly notified to firm** for appropriate action.

Its objective is to ensure that independence requirements are satisfied.

At least **annually**, firm should **obtain written confirmation** of compliance with P&P on independence from **all firm personnel** required to be independent in terms of requirements of the Code.