

Chapter - 11 "Ethics and Terms of Audit Engagement"

- Topics to be covered:
- ✓(1) Ethics and Fundamental Principles
 - ✓(2) Independence of Auditors
 - (3) Professional Skepticism
 - (4) SA-210 "Agreeing the Terms of Audit Engagement"
 - (5) Audit Quality (SQC-1 and SA-220)

(1) Ethics and Fundamental Principles:

(A) Meaning of Ethics: Ethics may be defined as:
"Principles of conduct governing an individual or group"

Ethics have manifold importance in accounting and auditing like other profession of law and medicine.

A professional accountant is abide by the provisions of CA Act, 1949 and Schedules thereto; any non-compliance may attract consequences like imposition of fine, removal from membership etc.

(B) Principle Based Approach vs. Rule Based Approach:

- Requires compliance with spirit of Ethics

- Requires Professional Accountants to exercise Professional Judgment based on - Professional Experience;

- Skills; and

- Expertise.

- Requires strict follow-up of established Rules.

- Spirit of Ethics may be overlooked.

- Rule Based approach is rigid in nature as every practical situation may not be dealt with, hence is having narrow outlook.

(c) Fundamental Principles: Fundamental Principles establishes the standard of behaviour expected of a professional accountant.

A Professional Accountant shall comply with each of the fundamental principles.

Code of Ethics issued by ICAI prescribes the following fundamental principles:

(i) Integrity

(ii) Objectivity

(iii) Professional Competence and Due Care (PCDC)

(iv) Confidentiality

(v) Professional Behaviour

(i) Integrity: Principle of integrity requires the auditor to be straight forward and honest.

It implies fair dealings and transparency.

Professional Accountant should not be associated with any report, returns, communication or information, which may:

(a) contain any false statement or misleading information; or

(b) omits any required information when such omission could be misleading.

(ii) Objectivity: Professional judgement of auditor should not be compromised due to

- any biasness;

- conflict of interest; or

- undue influence of others.

(iii) Professional competence and due care: It requires the following:

- (a) Attain and maintain professional knowledge and skills to that level so as to ensure that professional work is performed in accordance with the technical and professional standards.
- (b) Act diligently and in accordance with Technical and Professional standards
- (c) Exercise due care while performing professional work.

(iv) Confidentiality: Do not disclose the information acquired during the course of professional work with the others, unless:

- (a) required by law or regulation;
- (b) permitted by client or employer;
- (c) there is a professional duty to disclose.

(v) Professional Behaviour: Auditor must comply with the applicable legal and regulatory requirements; and should avoid any conduct that discredit the profession

Principle	Key words	Example
(1) Integrity	<u>Straight forward, honest, fair, transparency</u>	<u>Certifying F.S.</u> in circumstances when F.S. <u>conveys misleading information</u> .
(2) Objectivity	-Biasness; Conflict of Interest, Undue influence.	- <u>Opinion of auditor highly influenced by Mngt.</u>
(3) PCDC	Professional knowledge and skills, <u>Diligently</u> ; <u>due care</u>	- <u>Expressing opinion on F.S.</u> without <u>Examination of records</u> .
(4) Confidentiality	No Disclosure of info.	<u>Auditor shares sensitive data of client with relatives.</u>
(5) Professional behaviour	Compliance with <u>LLR</u> ; Avoid - Misconduct	<u>Non-compliance of Sec. 139 and 140.</u>

(a) Independence of Auditor: Independence is a state of mind and personal characteristic of a person.

It implies that judgement of a person should not be subordinate to the wishes or direction of another person who might have engaged him.

Perspectives of Independence: Independence of auditor must not exist in fact, but should also be appears to exist to all reasonable persons like shareholders, Government, Regulatory authorities, lenders etc.

There are two inter-linked perspectives of Independence.

(i) Independence of Mind

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State of Mind that permits an Opinion without being affected by Influences that Compromises

- Professional Judgement;
- Integrity
- Objectivity; and
- Professional Skepticism.

(ii) Independence of Appearance

↓ (Visible standards of Independence)
Avoidance of facts and Circumstances that are so significant

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that a reasonable third party would reasonably conclude that firm's integrity, objectivity and professional skepticism are compromised.

For Ex: Eligibility requirements as covered u/s 141 of Companies Act, 2013.

Ex: Auditor (being a director of Co.) expresses opinion on f.s. without being influenced by relationship as director → Independence of appearance affected.

Ex: Auditor (not related with client in any manner) → Independence of Mind
Expresses opinion under undue influence of BOD → affected.

Ex: Auditor (having business relationship with holding Co. of client) expresses opinion under undue influence of BOD of holding company → Independence of Mind as well as appearance affected.

Threats to Independence: 5 types

- (i) Self Review Threat
- (ii) " Interest "
- (iii) Advocacy "
- (iv) Intimidation "
- (v) Familiarity "

(i) Self-Review Threat: Threat that occurs when a previous judgement to be re-evaluated by professional accountant responsible for that judgement.

For Ex: Auditor engaged for audit of f.s. was also responsible for compilation of f.s.

Auditor having recently been a director of the company.

(ii) Self-Interest threat: Threat that occur as a result of financial or other interest of a professional accountant.

Examples:

- (a) Direct or indirect financial interest in a client.
- (b) Loan or guarantee from a client.
- (c) undue independence on client's fees.

- (d) Potential employment with client.
- (e) Contingent fees for audit engagement.

(iii) Advocacy threat: Threat that occurs when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised.

Ex: Auditor dealing with shares and securities of client.
- " acting as advocate for client in litigation's representative

(iv) Intimidation threat: Threat that occurs when a professional accountant may be deterred from acting objectively by threats - actual or perceived.

For Ex.: (a) Threat of termination/removal.

(b) " of not allowing bonus or due promotion.

(v) Familiarity threat: Threat that occur when a professional accountant because of a relationship becomes too sympathetic to the interest of other (client).

For Ex:

(a) Long association between auditor and the client.

(b) close relative of audit team member is in a senior position with client company.

(c) former partner of audit firm being a director of client.

Safeguards to Independence: ^{threats of} from book (Learning + Noting - H.W.)

Practice Questions - Q.1-Q.12 +