

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) Agreeing the terms of audit engagement (SA-210)
 - (5) Audit Quality (SQC-1 and SA 220)

(1) Ethics and Fundamental Principles:

(A) Ethics: Principles of conduct governing an individual or group. Ethics have manifold importance in profession of auditing like other profession of law and medicine.

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



- Requires compliance with spirit of ethics

(दिल से काम लेना)

- Requires professional accountants to exercise "Professional judgement" based on - Professional Experience

- Skills and

- Expertise



Requires strict follow-up of established Rules (किराग से काम लेना)

- Spirit of Ethics may be overlooked.

- Rule Based Approach is rigid in nature as every practical situation may not be dealt with.

(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.

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

It implies fair dealings and transparency.

Auditor should not be associated with any reports, returns, communications or information which may:

- (a) Contains any false statement or misleading information; or
- (b) Omits required information where such omission could be misleading.

(ii) Objectivity: Principle of objectivity requires that the 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 current 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; or
- ✓ (c) there is a professional duty to disclose.

(For Ex: Disclosure required under Professional Code of conduct)

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

(2) Independence of Auditors:

(A) Concept of Independence:- Independence is a State of Mind and Personal character.

- Independence may be defined as follows:

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

(B) Perspectives of Independence: "Independence of auditors must not exist in fact, but should also appear 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

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)

Avoidance of fact and Circumstances that are so significant

that a reasonable third party would reasonably conclude that

firm's Integrity, objectivity and Professional skepticism are compromised.

(E.g. Provisions covered U/s 141 of CA, 2013)

(C) Threats to Independence: 5 Types

(i) Self-Interest Threats: Threats that occur as a result of financial or other interest of a professional accountant.

Examples:

- (1) Direct or Indirect financial interest in a client.
- (2) Loan or guarantee from a client.
- (3) Undue dependence on client's fees.
- (4) Close business relationship with client.
- (5) Potential employment with client.
- (6) Contingent fees for audit engagement.

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

Example: Auditor engaged for audit of financial statements was also assigned responsibility for compilation of financial statements.

Ex: Auditor having recently been a director of the Company.

(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 company.

(iv) Familiarity Threat: Threat that occur when a professional accountant, because of a relationship, becomes too sympathetic to the interest of others.

For Ex:

- (i) Former Partner of audit firm being a director of client.
- (ii) Close relative of audit team member is in a senior position with the client.
- (iii) Long association between auditor and the client.

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

- For Ex:
- (i) Threat to auditor of termination/removal.
 - (ii) Threat to Employee of not allowing bonus or promotion.

(D) Safeguards to Threats:

(Noting - H.W.)