

Business Assurance, Ethics & Audit

Chartered Accountancy Corporate Level Advanced Audit & Assurance (AAA)

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BAE&A

BUSINESS ASSURANCE, ETHICS & AUDIT



BUSINESS LEVEL
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- ✓ Code of Ethics for Professional Accountants
 - ✓ Quality Control
 - ✓ Audit Documentation
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The Code of Ethics for Professional Accountants

The *Code of Ethics for Professional Accountants* issued by the Institute of Chartered Accountants of Sri Lanka (the CA Sri Lanka Code) sets out five fundamental principles of professional ethics and provides a conceptual framework for applying those principles. Members must apply this conceptual framework to identify threats to compliance with the principles, evaluate their significance and apply appropriate safeguards to eliminate or reduce them so that compliance is not compromised.

The CA Sri Lanka Code is based on the *Code of Ethics for Professional Accountants* published by the International Federation of Accountants (IFAC), and the latest version of it, available on the CA Sri Lanka website, is mandatory for all members (not just auditors) in respect of services after 1 January 2015. The Code is made up of three parts. Part A contains the fundamental principles of the Code and is applicable to all members; part B is applicable to professional accountants in public practice and part C is applicable to professional accountants in business. The conceptual framework for the Code is outlined in paragraph 100.6 and is as follows:

A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.

Fundamental principles of professional ethics

Members of CA Sri Lanka must comply with the fundamental principles set out in the *Code of Ethics for Professional Accountants* (**integrity, objectivity, professional competence and due care, confidentiality and professional behaviour**).

The five fundamental principles (as set out in Part A of the code) are summarized in the table which follows.

- **Integrity** A professional accountant should be straightforward and honest in all professional and business relationships.
- **Objectivity** A professional accountant should not allow bias, conflicts of interest or undue influence of others to override professional and business judgments.
- **Professional competence and due care**
A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing **professional services**.
- **Confidentiality** A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential

information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

- **Professional behaviour**

A professional accountant should comply with relevant laws and regulations and avoid any action that discredits the profession.

Confidentiality

Although auditors have a professional duty of **confidentiality**, they may be compelled by **law** or there may be a **professional right or duty** to disclose details of clients' affairs to third parties.

Confidentiality requires members to refrain from disclosing information acquired in the course of professional work except where:

- (a) Disclosure is permitted by law and is **authorised by the client** or the employer;
- (b) Disclosure is **required by law**, for example:
 - (i) Production of documents or other provision of evidence in the course of legal proceedings; or
 - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and
- (c) There is a **professional duty or right to disclose**, when not prohibited by law:
 - (i) To comply with the quality review of a member body or another professional body;
 - (ii) To respond to an inquiry or investigation by a member body or a regulatory body;
 - (iii) To protect the professional interests of a professional accountant in legal proceedings; or
 - (iv) To comply with technical standards and ethics requirements.

There are a number of factors to consider when deciding whether to disclose confidential information; the following are set out in the CA Sri Lanka Code:

- Whether the interests of all parties, (including affected third parties) could be harmed if the client or employer consents to the disclosure of information by the professional accountant
- Whether all the relevant information is known and substantiated, to the extent it is practicable
- The type of communication that is expected and to whom it is addressed
- Whether the parties to whom the communication is addressed are appropriate recipients

Integrity, objectivity and independence

The fundamental principles require that members behave with integrity in all professional and business relationships and they strive for objectivity in all their professional and business judgments. Objectivity is a state of mind but, in certain roles, the preservation of objectivity has to be shown by the maintenance of **independence** from those influences which could impair objectivity.

What is required in order to be, and be seen to be, independent?

Independence of mind is the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in appearance is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

It is very important that the auditor is **impartial** and **independent** of management, so that he can give an **objective** view on the financial statements of an entity. The onus is always on the auditor not only to be ethical but also to be **seen** to be ethical.

Independence and objectivity matter because of:

- (a) The **expectations** of those directly affected, particularly the members of the company. The audit should be able to provide **objective** assurance on the truth and fairness of the financial statements that the directors can never provide.
- (b) The **public interest**. Companies are public entities, governed by rules requiring the disclosure of information.

What can the auditor do to preserve objectivity?

The simple answer would be to **withdraw from any engagement** where there is the **slightest threat** to objectivity. However, there are disadvantages in this strict approach.

- Clients may lose an auditor who knows their business.
- It denies clients the freedom to be advised by the accountant of their choice.

A better approach would be to **consider** whether the **auditors' own objectivity** and the **general safeguards** operating in the professional environment are **sufficient** to offset the threat and to **consider** whether **safeguards over and above** the general safeguards are required, for example specified partners or staff not working on an assignment.

Although it may not be desirable to withdraw from an engagement or to refuse to act for a client, in some cases this may be the only option if the threat to independence is too great.

Threats to the fundamental principles

Threats to independence and objectivity may arise in the form of **self-interest, self-review, advocacy, familiarity** and **intimidation threats**.

Appropriate **safeguards** must be put in place to eliminate or reduce such threats to acceptable levels.

Threats to independence and objectivity

Compliance with the fundamental principles of professional ethics may potentially be threatened by a wide range of different circumstances. These generally fall into five categories:

- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation

Although we may talk about circumstances resulting in threats under a particular threat heading (such as self-interest) it is important to note that certain situations give rise to more than one type of threat.

➤ Self-interest

A self-interest threat is the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behaviour.

Self-interest threats may arise as a result of the financial or other interests of members or of immediate or close family



- ✓ Financial interests
- ✓ Recruitment
- ✓ Close business relationships
- ✓ Employment with assurance client
- ✓ Partner on client board
- ✓ Family and personal relationships
- ✓ Gifts and hospitality
- ✓ Loans and guarantees
- ✓ Overdue fees
- ✓ % or contingent fees
- ✓ High % of fees
- ✓ Lowballing

(i) Financial interests

A **financial interest** exists where an audit firm has a financial interest in a client's affairs, for example, the audit firm owns shares in the client, or is a trustee of a trust that holds shares in the client.

The CA Sri Lanka Code does not allow the following to own a direct financial interest, or an indirect material financial interest, in a client:

- The **audit** firm, or a network firm (see note below)
- A **member** of the audit team
- An **immediate family member of a member** of the audit team (Note: Network firms are discussed in Section 3.2.)

The following safeguards will therefore be relevant:

- *Disposing of the interest*
- *Removing the individual from the team, if required*
- *Keeping the client's audit committee informed of the situation*
- *Using an independent partner to review work carried out, if necessary*

Audit firms should have quality control procedures requiring staff to disclose relevant financial interests for themselves and close family members. They should also foster a culture of voluntary disclosure on an ongoing basis, so that any potential problems are identified in a timely manner.

(ii) Close business relationships

Close business relationships between a firm, or an audit team member, or a member of that individual's immediate family, and the audit client (or its management), arise from commercial relationships or common financial interests.

Examples of when an audit firm and an audit client have a close business relationship include:

- Having a financial interest in a joint venture with either the client or a controlling owner, director, officer or other individual who performs senior managerial activities for that client
- Arrangements to combine one or more services or products of the firm with one or more services or products of the audit client and to market the package with reference to both parties
- Distribution or marketing arrangements under which the firm acts as distributor or marketer of the audit client's products or services or vice versa

*It will be necessary for the partners to judge the materiality of the interest and therefore its significance. However, **unless the interest is clearly insignificant, an audit provider should not participate in such a venture with an audit client.** Appropriate safeguards are therefore to end the assurance provision or to terminate the (other) business relationship.*

(iii) Employment with an audit client

It is possible that staff might transfer between an audit firm and a client, or that negotiations or interviews to facilitate such movement might take place. Both situations are a threat to independence:

- An audit staff member might be motivated by a desire to impress a future possible employer (objectivity is therefore affected: self-interest threat)
- A former audit partner turned Finance Director has too much knowledge of the audit firm's systems and procedures. In general there may be **familiarity** and **intimidation threats** when a member of the audit team joins an audit client. If a '**significant connection**' still **remains** between the audit firm and the former employee/partner, **then it may be that no safeguards could reduce the threat to an acceptable level**. This would be the case where:
 - The individual is entitled to benefits from the audit firm (unless fixed and predetermined, and not material to the firm)
 - The individual continues to participate in the audit firm's business or professional activities.

If there is no significant connection, then the threat depends on:

- The **position** the individual has taken at the client;
- Any **involvement** the individual will have **with the audit team**;
- The **length of time** since the individual was a member of the audit team or partner of the firm; and
- The **former position** of the individual **within the audit team or firm**, for example, whether the individual was responsible for maintaining regular contact with the client's management or those charged with governance.

Safeguards could include:

- **Modifying the audit plan**;
- **Assigning individuals** to the audit team **who have sufficient experience** in relation to the individual who has joined the client; or
- **Having an independent professional accountant review** the work of the former member of the audit team.

(iv) Temporary staff assignments

Staff may be loaned to an audit client, but only **for a short period of time**.

Staff must not assume management responsibilities, nor undertake any audit work that is prohibited elsewhere in the Code.

The audit client must be responsible for directing and supervising the activities of the loaned staff.

Possible safeguards include:

- *Conducting an additional review of the work performed by the loaned staff*
- *Not giving the loaned staff audit responsibility for any function or activity on the audit, which they performed during the temporary staff assignment; or*
- *Not including the loaned staff in the audit team.*

(v) Partner on client board

A partner or employee of an audit firm should not serve on the board of an audit client.

It may be acceptable for a partner or an employee of an audit firm to perform the role of company secretary for an audit client, if the role is essentially administrative.

(vi) Family and personal relationships

Family or close personal relationships between audit firm and client staff could seriously threaten independence. Each situation has to be evaluated individually. Factors to consider are:

- The individual's responsibilities on the audit engagement
- The closeness of the relationship
- The role of the other party at the audit client

When an immediate family member of a member of the audit team is a director, an officer or an employee of the audit client in a position to exert direct and significant influence over the subject matter information of the audit engagement, the individual should be removed from the audit team.

The audit firm should also consider whether there is any threat to independence if an employee who is not a member of the audit team has a close family or personal relationship with a director, an officer or an employee of an audit client.

A firm should have quality control policies and procedures under which staff should disclose if a close family member employed by the client is promoted within the client.

If a firm inadvertently violates the rules concerning family and personal relationships they must apply additional safeguards, such as undertaking a quality control review of the audit and discussing the matter with the audit committee of the client, if there is one.

(vii) Compensation and evaluation policies

There is a self-interest threat when a member of the audit team is evaluated on selling non-assurance services to the client. The significance of the threat depends on:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services

- The role of the individual on the audit team
- Whether promotion decisions are influenced by the sale of such services.

The firm should either revise the compensation plan or evaluation process, or put in place appropriate safeguards. Safeguards include:

- *Removing the member from the audit team*
- *Having the team member's work reviewed by a professional accountant.*

(viii) **Gifts and hospitality**

Unless the value of the gift or hospitality is **clearly insignificant**, a firm or a member of an audit team should not accept.

(ix) **Loans and guarantees**

The advice on loans and guarantees falls into two categories:

- The client is a bank or other similar institution
- Other situations

If a lending institution client (eg a bank) lends an immaterial amount to an audit firm or member of assurance team on normal commercial terms, there is no threat to independence.

If the loan is material it will be necessary to apply appropriate safeguards to bring the risk to an acceptable level.

A suitable safeguard is likely to be an independent review (by a partner from another office in the firm).

Loans to members of the audit team from a bank or other lending institution client are likely to be material to the individual, but provided that they are on normal commercial terms, these do not constitute a threat to

An audit firm or individual on the audit engagement should not enter into any loan or guarantee arrangement with a client that is not a bank or similar institution (unless immaterial to both parties, which is unlikely).

The self-interest threat created by entering into such an arrangement would be so significant that no safeguard would be able to reduce the threat to an acceptable level. In addition loans should not be made by an audit firm or an audit team member to an audit client.

(x) **Overdue fees**

A self-interest threat arises if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. Generally the firm will require payment of such fees before such audit report is issued.

However, if fees remain unpaid after the report has been issued, the existence and significance of any threat must be evaluated and safeguards applied when necessary. One safeguard might be to arrange for an additional professional accountant who did not take part in the audit engagement to review the work performed.

Also, in a situation where there are overdue fees, the auditor runs the risk of, in effect, making a loan to a client, whereupon the guidance above becomes relevant.

Audit firms should guard against significant fees building up by discussing the issues with those charged with governance and, if necessary, the possibility of resigning if overdue fees are not paid.

(xi) Contingent fees

Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. A firm is not permitted to enter into any fee arrangement for an audit or assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

It would also usually be inappropriate to accept a contingent fee for non-assurance work from an audit client, as it will create a self-interest threat.

The engagement should not be accepted if the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement.

Where contingent fees on non-assurance services are not prohibited by the rules above, the following factors must be considered in deciding whether a contingent fee is acceptable or not:

- The range of possible fee outcomes
- The degree of variability
- The basis of the fee
- Any independent review
- The effect of the transaction on the assurance engagement

The significance of the threats should be evaluated and safeguards should be considered and applied as necessary, such as

- *Disclosing to the audit committee the extent and nature of fees charged*
- *Independent review or determination of the final fee*
- *Quality and control policies and procedures*

(xii) High percentage of fees

When a firm receives a high proportion of its fee income from just one audit client, there is a **self-interest** or **intimidation threat**, as the firm will be concerned about losing the client. This depends on:

- The operating **structure** of the **firm**

- Whether the **firm** is established or **new**
- The **significance of the client** to the firm (both quantitatively and qualitatively)

Possible safeguards include:

- **Reducing the dependency** on the client;
- **External quality control reviews**; or
- **Consulting a third party**, such as a professional regulatory body or a professional accountant, **on key audit judgments**.

It is not just a matter of the audit firm actually being independent in terms of fees, but also of it being seen to be independent by the public. It is as much about public perception as reality.

The Code also states that a threat may be created where an individual partner or office's percentage fees from one client are high. The safeguards are as above, except that internal quality control reviews are also relevant.

(xiii) **Lowballing**

When a firm quotes a significantly lower fee level for an audit service than would have been charged by the predecessor firm, there is a significant self-interest threat. If the firm's tender is successful, the firm should apply

safeguards such as:

- *Maintaining records such that the firm is able to demonstrate that appropriate staff and time are allocated to the engagement*
- *Complying with all applicable auditing standards, guidelines and quality control procedures*

(xiv) **Recruitment**

Recruiting senior management for an audit client, particularly those able to affect the subject matter of an audit engagement, creates a self-interest threat for the audit firm. Audit providers should not make management decisions for the client. Their involvement could be limited to reviewing a shortlist of candidates, providing that the client has drawn up the criteria by which they are to be selected.

In addition to the self-interest threats discussed above, the **holding of client assets** also creates a self-interest threat to professional behaviour and may also create a self-interest threat to objectivity.

A professional accountant in public practice should not assume custody of client monies or other assets unless permitted to do so by law. If permitted by law the assets are kept separately and closely controlled and accounted for.

➤ Self-review threat

Self-review threats arise when a member reviews his or her own work or advice as part of an assurance engagement. Circumstances that may give rise to such threats include the following:

- ✓ Recent service with assurance client
- ✓ General other services
- ✓ Other services
- ✓ Corporate finance
- ✓ Internal audit services
- ✓ Tax services
- ✓ Valuation services
- ✓ Preparing accounting records and financial statements

(i) Recent service with an audit client

Individuals who have been a **director or officer of the audit client, or an employee in a position to exert direct and significant influence** over the preparation of the accounting records or financial statements in the period covered by the audit report should not be assigned to the audit team.

If an individual had been closely involved with the client before the period covered by the audit report, the audit firm should consider the threat to independence arising and,

apply appropriate safeguards, such as:

- *Obtaining a quality control review of the individual's work on the assignment*
- *Discussing the issue with the audit committee*

(ii) Provision of general other (non-audit) services

Providing non-assurance services to audit clients may create threats to the independence of the firm or members of the audit team. Audit firms must evaluate any threat arising and decline to provide a non-audit service if the application of safeguards will not reduce the threat to an acceptable level.

Provision of some non-audit services to audit clients will not create an insurmountable threat and can be provided when certain safeguards are in place. Depending on the nature of the other service safeguards may not even be necessary.

An important question to ask when deciding whether provision of non-audit services to an audit client is acceptable is 'does providing the service result in the audit firm carrying out activities that would generally be considered a **management responsibility**'?

Whether an activity is a management responsibility depends on the circumstances and requires the relevant partners at the audit firm to use judgment.

The following are generally considered to be management responsibilities:

- Setting policies and strategic direction
- Directing and taking responsibility for the actions of the entity's employees
- Authorizing transactions
- Deciding which recommendations of the firm or other third parties to implement
- Taking responsibility for the preparation and fair presentation of the financial statements
- Taking responsibility for designing, implementing and maintaining internal control

Activities that are **routine and administrative**, or involve matters that are insignificant, generally are deemed **not** to be a management responsibility.

(iii) Preparing accounting records and financial statements

There is clearly a significant risk of self-review if a firm prepares accounting records and financial statements and then audits them. However, in practice, auditors routinely assist management with the preparation of financial statements and give advice about accounting treatments and journal entries.

Audit firms must therefore analyse the risks arising and put safeguards in place to ensure that the risk is at an acceptable level. Safeguards include:

- *Using staff members other than audit team members to carry out work*
- *If non-audit services are performed by a member of the audit team, using an independent partner or senior staff member (not part of the audit team) to review the work performed*
- *Obtaining client approval for work undertaken the rules are more stringent when the client is listed or public interest.*

Except in emergency situations, a firm must not provide to a public interest audit client any accounting and bookkeeping services, including payroll services, or prepare financial statements on which the firm will express an opinion. The same rule applies to financial information which forms the basis of the financial statements.

Note that an 'emergency situation' as stated above is where it is impractical for the audit client to make other arrangements. However, in this situation the accountancy services must be provided by a separate team to that performing the audit and it should not be a long or recurring service. Those charged with governance should be kept informed of the situation.

(iv) Valuation services

A **valuation** comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

If an audit firm performs a valuation which will be included in financial statements audited by the firm, a self-review threat arises.

Audit firms should not carry out valuations on matters which will be material to the financial statements which involve a significant degree of subjectivity.

If the valuation is for an immaterial matter, the audit firm should apply safeguards to ensure that the risk is reduced to an acceptable level. Matters to consider when applying safeguards are the extent of the audit client's knowledge of the relevant matters in making the valuation and the degree of judgement involved, how much use is made of established methodologies and the degree of uncertainty in the valuation.

Safeguards include:

- *Second partner review*
- *Confirming that the client understands the valuation and the assumptions used*
- *Ensuring the client acknowledges responsibility for the valuation*
- *Using separate personnel for the valuation and the audit*

(v) Taxation services

The CA Sri Lanka Code states:

In many jurisdictions, the firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.



(vi) Internal audit services

A firm may provide certain internal audit services to an audit client depending on the nature of the services and the type of entity being audited.

An audit firm's personnel **should not assume a management responsibility** as a result of providing internal audit services.

To avoid inadvertently assuming a management responsibility the audit firm must make sure senior management at the client accepts responsibility for designing, implementing and maintaining internal control and continue to approve the scope, risk and frequency of internal audit services. Client management should also remain responsible for evaluating and acting on internal audit findings and for reporting significant findings to those charged with governance.

For internal audit services provided that create self-review threat, it may be appropriate to use.

safeguards such as

- *using personnel not involved in the audit,*
- *ensuring that an employee of the client is designated responsible for internal audit activities and*
- *ensuring that the client approves all the work that internal audit does.*

(vii) Corporate finance

Certain aspects of corporate finance will create self-review threats that cannot be reduced to an acceptable level by safeguards.

Where the effectiveness of corporate finance advice depends on a particular accounting treatment or presentation in the financial statements, and the audit team has reasonable doubt as to the appropriateness of that treatment and the consequences of the corporate finance advice will have a material effect on the financial statements, the corporate finance advice must not be provided.

In addition, **assurance firms are not allowed to promote, deal in or underwrite an assurance client's shares**. They are also not allowed to commit an assurance client to the terms of a transaction or consummate a transaction on the client's behalf. Other corporate finance services, such as assisting a client in defining corporate strategies, assisting in identifying possible sources of capital and providing structuring advice may be acceptable providing that

Safeguards are used, such as

- *using different teams of staff and*
- *ensuring no management decisions are taken on behalf of the client.*

(viii) IT systems services

In general, IT systems work for audit clients not related to internal control over financial reporting is not deemed to create a threat, as long as no management responsibility is assumed by the audit firm's personnel. The implementation of 'off-the-shelf' accounting or financial information reporting software, and making recommendations in relation to a system not designed, implemented or operated by the audit firm, is also permitted.

However significant threats arise when the audit firm provides **services to an audit client involving the design or implementation of IT systems** that:

- (a) Form a **significant part of the internal control** over financial reporting, or
- (b) Generate **information that is significant to the client's accounting records or financial statements**

Services relating to design and implementation of IT systems of the nature discussed above may be provided, but only if the client acknowledges its responsibility for establishing and monitoring a system of internal controls, and management (or a competent employee at the client) maintains responsibility for making all relevant management decisions, evaluation of the system and the operation of the system.

(ix) Other services

The audit firm might sell a variety of other services to audit clients, such as:

- Litigation support
- Legal services

The audit firm should consider whether there are any barriers to independence and consider whether the threat to independence could be reduced to an acceptable level by appropriate safeguards.

➤ **Advocacy threat**

Advocacy threats arise in those situations where the audit firm promotes a position or opinion to the point that subsequent objectivity is compromised.

Examples include commenting publicly on future events in particular circumstances, having made assertions without detailing the assumptions, or acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

Advocacy threats might also arise

- The firm promoted shares in a listed audit client.
- Acting in an advocacy role for an audit client in resolving a dispute or litigation when the amounts involved are material to the financial statements on which the firm will express an opinion

.....is not permitted by the CA Sri Lanka Code. In addition the Code does not allow the appointment of a partner or an employee of the firm as General Counsel for legal affairs of an audit client.

Where advocacy threats arise, and the work or actions are permitted by the Code, then relevant safeguards might include

- *using different departments to carry out the work and*
- *making disclosures to the audit committee.*

Remember, the audit firm has the option to withdraw from an engagement if the risk to independence is too high.

➤ Familiarity threat

Having an audit client for a **long period of time may create a familiarity threat** to independence. The severity of the threat depends on factors such as how long an individual has been on the audit team, how senior the person is, whether the client's management has changed and whether the client's accounting issues have changed in nature or complexity.

*Possible **safeguards** include:*

- **Rotating the senior personnel off the audit team**
- **Having a professional accountant who was not a member of the audit team to review the work of the senior personnel**
- **Regular independent internal or external quality reviews of the engagement**

The rules for listed entities are stricter.

If an individual is a key audit partner for seven years, they must be rotated off the audit for two years. During this time they cannot be on the audit team, and cannot consult with the audit team or the client on any issues that may affect the engagement (including giving just general industry advice).

The Code does allow some flexibility here. If key partner continuity is particularly beneficial to audit quality, and there is some unforeseen circumstance (such as the intended engagement partner becoming

seriously ill), the key audit partner may remain on the audit team for up to one additional year.

If the firm has only a few people capable of being a key audit partner for a public interest client, it is possible for an independent regulator to give permission for an audit partner to remain a key audit partner indefinitely, provided alternative safeguards specified by that regulator are applied (such as external review).

➤ Intimidation threat

An intimidation threat arises when members of the audit team may be deterred from acting objectively by threats, actual or perceived. These could arise from family and personal relationships, litigation or close business relationships.

These are also examples of self-interest threats, largely because intimidation may only arise significantly when the audit firm has something to lose.

The most obvious example is when the client threatens to sue, or does sue, the audit firm for work that has been done previously. The firm is then faced with the risk of losing the client, bad publicity and the possibility that it will be found to have been negligent. This could lead to the firm being under pressure to produce an unmodified audit opinion in the auditor's report. Generally, audit firms should seek to avoid such situations arising. If they do arise, factors to consider are:

- The materiality of the litigation
- The nature of the audit engagement
- Whether the litigation relates to a prior audit engagement

The following safeguards could be considered:

- *Disclosing to the audit committee the nature and extent of the litigation*
- *Removing specific affected individuals from the engagement team*
- *Involving an additional professional accountant on the team to review work*

However, if the litigation is at all serious, it may be necessary to resign from the engagement, as the threat to independence may be too great.

Practice Question on Independence

You are an audit manager in Jayakody & Co and are preparing for the audit of Bigcorp, a public limited liability company, for the year ending 31 December 20X5. Bigcorp has rapidly expanded its operations over the past few years, and is now one of your firm's biggest clients. Bigcorp has been an audit client for nine years and Jayakody & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 March 20X5 remains unpaid. The audit team available for this year's audit is most of the staff from last year, including Mr Ranatunga, an audit partner and Mr Liyanage, an audit senior. Mr Ranatunga has been the audit partner since Bigcorp became an audit client. You are aware that Nisha Ranatunga, the daughter of Mr Ranatunga, has recently been appointed the financial director at Bigcorp. Nisha has asked all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year. Nisha has said it is a celebration of her new appointment.

Required

Analyse the risks to independence arising in carrying out your audit of Bigcorp for the year ending 31 December 20X5, and suggest safeguards to mitigate each of the risks identified.

Risks to independence

Audit Partner

Mr Ranatunga has been the audit partner on the audit of Bigcorp for the last nine years. His independence and objectivity are likely to be impaired as a result of this close relationship with a key client and its senior management. The CA Sri Lanka Code requires key audit partners to be rotated after seven years and Mr Ranatunga's involvement for nine years already contravenes this rule. This threat could (and should) be addressed by appointing another audit partner to the audit of Bigcorp and rotating partners at suitable intervals thereafter.

Tax Fees Outstanding

There are taxation fees outstanding from Bigcorp for work that was done over nine months previously. In effect, Jayakody & Co are providing an interest-free loan to Bigcorp. This can threaten independence and objectivity of the audit firm as it may not want to modify the audit opinion in case the outstanding fees are not paid.

This can be addressed by discussing the issue with the directors of Bigcorp and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

Fee Dependence

Bigcorp is one of Jayakody & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also the company is growing

rapidly. Objectivity and independence are considered to be threatened to the degree that an independent engagement review is needed by an external firm or regulator (and disclosure to those charged with governance) if the fees for audit and recurring work are a significant proportion of the firm's total fees for a listed client such as Bigcorp.

This threat could be mitigated by reviewing the total of the audit and recurring fee income from Bigcorp as a percentage of Jayakody & Co's total fee income on a regular basis, and possibly limiting the provision of the other services if deemed necessary to maintain independence.

Relationship to Financial Director of Bigcorp plc

Nisha Ranatunga, the daughter of Mr Ranatunga, has recently been appointed the Financial Director of Bigcorp. The independence of Mr Ranatunga could be threatened because of their close family relationship. The extent of the threat depends on the position the immediate family member holds with the client and the role of the professional on the assurance team. As Financial Director, Nisha has direct influence over the financial statements and as engagement partner, Mr Ranatunga has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence. This threat to independence could (and should) be mitigated by the appointment of another audit partner to this client.

Meal

The fact that Nisha Ranatunga wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence as it might influence the audit team's decisions once they start the audit of the financial statements. The ethics rules state that gifts or hospitality from the client should not be accepted unless the value is trivial and inconsequential. This threat could be mitigated by declining the invitation.

Networks and network firms

Several accountancy firms have moved towards network models over recent years. This is where member firms are part of a larger structure, often sharing a name (or using a similar name) and professional resources. As part of a global network, member firms have been able to sell services based on the value and reputation of their global brand name.

A network firm is a firm or entity belonging to a network. A network is defined in the CA Sri Lanka Code as a larger structure aimed at cooperation and:

- (a) Aimed at profit or cost sharing; or
- (b) Shares common ownership, control or management; or
- (c) Shares common quality control policies and procedures;
- (d) Shares common business strategy;
- (e) Uses a common brand name; or
- (f) Shares a significant part of professional resources (eg staff are shared).

Where a firm is a network firm it must be **independent** of the financial statement audit clients of other firms within its network. When considering the threats to independence and related safeguards discussed in this Section, the auditor must also consider any implications arising as a result of being in a network.

For example when considering if a financial interest exists in an audit client which could impair independence (see 3.1.1) the financial interests of both the firm **and** any network firm must be considered and the appropriate safeguards (disposing the interest) applied.

Conflicts of interest

In some ways conflict of interest issues are similar to the difficulties firms have in maintaining independence. They can arise in a variety of circumstances and each problem has to be dealt with on its own merits. A professional accountant must take reasonable steps to identify circumstances that could pose a conflict of interest because such circumstances may create threats to compliance with the fundamental principles.

When considering whether to accept a client or when there is a change in a client's circumstances, audit firms must take reasonable steps to ascertain whether there is a conflict of interest or if there is likely to be one in the future.

Conflicts between members' and clients' interests

A conflict between members' and clients' interests might arise if members compete directly with a client, or have a joint venture or similar with a company that is in competition with the client. This may threaten the member's objectivity.

Members and firms should not accept or continue engagements in which there are, or are likely to be, significant conflicts of interest between members, firms and clients. Any form of financial gain which accrues or is likely to accrue to the member as a result of an engagement, or as a result of using information known to him/her about a client, will usually always amount to a significant conflict of interest between the member and client.

Members should evaluate the threats arising from a conflict of interest that are not significant and apply safeguards where necessary to reduce them to an acceptable level. One applicable safeguard is notifying the client of the conflict of interest and obtaining their consent to act.

Conflicts between the interests of different clients

Conflicts of interest can arise when a firm has two (or more) audit clients, both of which have reason to be unhappy that their auditors are also auditors of the other company. This situation frequently arises when the companies are in **direct competition** with each other, and particularly when the **auditors have access to** particularly **sensitive information**. In such circumstances objectivity and confidentiality may be threatened.

Audit firms are at liberty to have clients who are in competition with each other. However, the firm should ensure that it is not the subject of a dispute between the clients. It must also manage its work so that the interests of one client do not adversely affect another client.

However, **where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued.**

Where interests are **not** materially prejudiced but threats to objectivity or confidentiality arise due to the auditor acting for two clients whose interests are in conflict, then the firm must:

- (a) Evaluate the significance of any threats
- (b) Apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level

Conflicts can, of course, be avoided by not accepting any appointment or assignment in which they seem likely to occur, but this may not be practicable. Where threats may arise as a result of a conflict of interests, the primary safeguard will always be to notify all known relevant parties that the member or firm is acting (or plans to act) for two or more parties in respect of a matter where their respective interests are in conflict and **obtaining their consent to act.**

As well as obtaining consent additional safeguards include:

- (a) The use of separate engagement teams*
- (b) Procedures to prevent access to information (such as strict physical separation of such teams, confidential and secure data filing, password protection)*
- (c) Clear guidelines for members of the engagement team on issues of security and confidentiality*
- (d) The use of confidentiality agreements signed by employees and partners of the firm*
- (e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements*
- (f) Advising one or more clients to seek additional independent advice.*

Larger firms can often apply the safeguards (a) to (d) above by building a '**Chinese wall**' within the firm. This would mean that the respective audits are undertaken by different audit 'groups', the engagement partners are different and all the other audit staff are allowed to work on only one of the clients. In addition records are only accessible to the teams working on their particular client. Small firms, on the other hand, may struggle to implement such procedures. A final point to note is that if consent to act for another party has not been obtained from an existing client then the firm should not act for one of the parties.

Questions.....

Question 01

You are the partner in charge of technical and ethical issues at your firm. The following situations have arisen for which your opinion is sought.

(a) The managing director of Toho Ltd. has approached your firm and requested a second opinion on the audit report which its current external auditors are proposing to give on the financial statements for the year ended 31 March 2012. The proposed audit report expresses a modified opinion due to disagreement over an accounting policy adopted in the financial statements.

(6 marks)

(b) Code Write (Pvt) Limited has developed a software system to facilitate maintaining a Fixed Assets Register. They have made a proposal to your firm to promote their product to other clients of the firm. For every sale made on your firm's recommendation, your firm will be entitled to an introduction fee of 10% of the sale value.

(4 marks)

(c) Your firm has been requested by Thomas & Co (a new client to whom you do not provide any other service) to undertake the preparation of their executive payroll. To ensure confidentiality of the executives' salaries, Thomas & Co have indicated that they will transfer adequate funds to your firm so that your firm can pay out the salaries. To enable this process a deposit of one month salary will be held by your firm.

(5 marks)

Identify the ethical issues that may arise to your firm from these requests and state, with reasons, how your firm should deal with them.

(Total 15 marks)

Question 02

Good Accounting Associates (GAA), is a firm of Chartered Accountants that was established 25 years ago. GAA has 3 Partners, two of them being Fellow Chartered Accountants. The number of staff including professional employees is 53. You are a Senior Manager at GAA, having served

the firm for 12 years since you joined the firm as a trainee. GAA provides many professional services to clients including audit and assurance, internal audit and tax related work.

Samanala Group PLC is the firm's largest client, a listed entity in the Colombo Stock Exchange. GAA has provided professional services to Samanala Group PLC since its incorporation 20 years ago and in addition to the statutory audit, it also provides many other services including tax planning for the company and the founder chairman and his wife, Saman and Nalani Perera.

Samanala Group is engaged in the excavation and processing of a rare mineral situated in the northern part of Sri Lanka. It is the only company that is engaged in such business in Sri Lanka. The processing carried out by the company is very complex and the success of the company is attributed to the founder chairman's active engagement in all activities using his knowledge of the business.

You have been a part of the professional teams since you joined GAA in providing various professional services to Samanala Group PLC in different capacities. Samanala Group PLC has a very good professional relationship with Manoj Silva FCA, who has been the Partner in charge of the audit of Samanala Group PLC since its inception. The firm GAA is also happy with your performance standards and the Senior Partner Manoj Silva has appointed you to be the overall in charge of all services that GAA provides to Samanala Group PLC. Due to Samanala Group PLC's complex business environment, the company has requested the Senior Partner to retain the same key staff members this year too in order to carry out a smooth audit. Earlier in the financial year, the finance director of Samanala Group PLC retired, and was succeeded by a former manager of GAA who had managed the audits and other professional services for the last few years before you took over as the overall in charge.

Required:

- (a) List four (04) ethical and/or professional issues in the above situation. (4 marks)
- (b) Identify the measures which should be implemented by GAA in order to mitigate any threats to auditor's independence and objectivity. (6 marks)

Question 03

You are a partner in Perera & Company. Your firm has been providing internal audit services to International Services (Pvt.) Ltd (ISL) for the last 2 years. In providing this service you have built up a professional relationship with the management of ISL. Your network firm, Perera Corporate Services (Pvt.) Limited (PCSL) is the company secretary of ISL. All work undertaken by PCSL is managed by Mrs. Silva, a Chartered Secretary. The statutory audit for the year ended 31 March 2013 is in progress and the directors of ISL have approached you to obtain an opinion from you regarding a disagreement they have with their current auditors. They have requested your written opinion so that it may be presented to their current auditors. Arising from this disagreement with the current auditors, the directors of ISL have also requested the following services from your firm:

- (i) that your firm be appointed the external auditor of ISL ;and
- (ii) (ii) that you, as the proposed engagement partner, attend the company's monthly board meetings.

Requirement Discuss the potential threats that will arise if you decide to provide the additional services requested by ISL and describe what safeguards (if any) could be put in place to mitigate those threats according to the Code of Ethics issued by the Institute of Chartered Accountants

Question 04

(A) You are a senior manager in SHP & Co, and you are dealing with several listed audit clients. The following matters were noted when you were reviewing the engagement acceptance documents. Details are as follows:

- (a) Your firm accepted the audit of WP Plc for the year ending 31 December 2013. After several discussions with the client, you agreed to a fee that is significantly lower than the fee you will otherwise charge.

(b) Mr. Nimal De Silva, FCA is the engagement partner for the audit of PHAC Plc. The current financial year is Mr. De Silva's 12th year as the engagement partner for the audit of PHAC Plc. Due to his long association with the client, Mr. De Silva has built a very good relationship with the client.

Evaluate the ethical and other professional issues raised, in respect of WP Plc and PHAC Plc. (6 marks)

(B) The principle of confidentiality imposes an obligation on professional accountants to refrain from;

(a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationship without proper and specific authority.

(b) Using confidential information acquired as a result of professional and business relationship to their personal advantage or the advantage of third parties.

State the circumstances where a professional accountant may be required to disclose confidential information or when such disclosure may be required. (4 marks) (Total 10 marks)

Question 05

Based on the ICASL code of ethics:

(a) State the principal threats to independence and objectivity which may arise in each of the scenarios mentioned below. (3 marks)

(b) Explain the safeguards that a firm/individual may consider taking to avoid the threats identified in part (a). (4 marks) (Total: 7 marks) Scenarios:

(i) Concord (Pvt) Limited (CPL) is a small new audit client of STU & Co (a firm of Chartered Accountants). The directors of CPL had requested STU & Co to provide assistance with

the year-end closing journal entries and preparation of the financial statements. The directors are aware that STU & Co has the technical expertise. They consider obtaining the assistance of STU & Co will help in finalising the statutory financial statements to file the tax returns on or before the required date.

- (ii) Durable (Pvt) Limited (DPL) is a construction company which was incorporated 3 years ago. The company negotiated 8 new contracts during the last financial year. All 8 contracts are to commence within the current financial year and are scheduled to be completed within the next 3 years. However, this situation has created the need for additional operational cash flows and the company is now planning to apply for a loan from a foreign bank operating in Sri Lanka. The bank requires a report from an independent party on the cash flow forecast, based on an independent examination. The directors of DPL had requested PRQ & Co (a firm of Chartered Accountants) to provide this report. They have also mentioned that they will pay 1% of the approved loan amount to PRQ & Co as professional fees, and the fee will only be paid once the loan is approved.
- (iii) Amali is an audit senior working at ASR & Co (a firm of Chartered Accountants). She is currently performing an assurance engagement (which commenced a week ago) at Omega PLC. After the commencement of the assurance engagement, the accountant of Omega PLC had given a letter that he will be resigning from the company within two months. Within a few days of receipt of the resignation letter by Omega PLC, the finance director (FD) spoke to Amali asking her to join Omega PLC as the accountant. The FD had mentioned to Amali that she can commence work within two months. The assurance engagement of Omega PLC is to be completed within 3 weeks.

Question 06

You are given the following scenarios:

- (i) You are the audit manager of Supiri Limited. You had commenced the audit for the year ended 31 March 2014 about 2 weeks back. You noticed that the audit fee for the year ended 31 March 2013 is still not settled and it is now about 10 months overdue.

- (ii) Mr. De Silva is the engagement partner of Brook Limited, which is a new audit client. Brook Limited was acquired by Trade Limited last week. Now Trade Limited fully owns Brook Limited. Mr. De Silva's wife, Kamini, is a director of Trade Limited.
 - (iii) You have been the audit manager of Three Star PLC for the last 8 years. The engagement quality control reviewer has requested that you should be rotated out of the audit. However the engagement partner does not agree with this request.
 - (iv) Your audit client First PLC has a significant investment in a private company which requires a valuation. First PLC had requested your firm to provide the valuation in order to record it in the financial statements. Based on the ICASL code of ethics, you are required to:
 - (a) Explain the principal threats to independence and objectivity which may arise in each of the scenarios mentioned above. (8 marks)
 - (b) Explain the safeguards that a firm/individual may consider taking to avoid the threats identified in part (a). (8 marks)
- (Total: 16 marks)

Question 07

You are the partner in charge of ensuring adherence to the code of ethics and standards at MSM Associates. The following matters have been brought to your attention. Identify the ethical issues that may arise for your firm from these matters and state, with reasons, how your firm should deal with them.

- (a) Your firm has quoted for the external audit of Plybags (Pvt) Limited. The fee proposed for the audit is significantly lower than the fees quoted by the previous auditor. (4 marks)
- (b) The managing director of ATC Ltd has approached your firm and requested a second opinion on the audit report which its current external auditors are proposing to give on the financial statements for the year ended 31 March 2011. The proposed audit report expresses an adverse opinion due to disagreement over a number of accounting policies adopted in the financial statements. (6 marks)

(c) Mr. Perera has been the audit partner of Mixsims (Pvt) Limited for the last 10 years. The manager who has handled the audit for the last 5 years has met with an accident and another manager who has no previous experience with the client was appointed to manage the assignment. (5 marks) (Total 15 marks)

Question 08

(a) State four (04) fundamental principles a Chartered Accountant is required to comply with, as per the Code of Ethics for Professional Accountants issued by the Institute of Chartered Accountants of Sri Lanka. (4 marks)

(b) The following scenarios are given in relation to Anuja & Co. where Anuja Perera is the senior partner.

Scenario 1 Anuja & Co. has been the auditors of Waruna Manufacturing Ltd (WML) for the past 22 years. Anuja Perera has been the engagement partner of the said audit throughout this period.

Scenario 2 Anuja Perera had also invested in 35% of the shares of Puthula Industries Ltd (PIL). As the previous auditor of PIL had communicated their inability to continue as the auditor of PIL a few days before the financial year end, the managing director of PIL had invited Anuja & Co to be the auditors of PIL.

- (i) Identify the ethical issues in the above scenarios. (2 marks)
- (ii) Explain how the ethical issues identified in (i) can be overcome by the relevant party. (4 marks) (Total: 10 marks)

Question 09

(a) A professional accountant should maintain confidentiality at all times.

List three (03) circumstances with an example each where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate. (6 marks)

(b) Your firm has been auditing the financial statements of Saman PLC for the last four years. Finance Director of Saman PLC has requested your firm to assist him in the recruitment of a senior manager to his finance team. Describe the course of action your firm would take in such a scenario. (4 marks) (Total 10 marks)

Question 10

Discuss the following instances in relation to the Code of Ethics for Professional Accountants published by the Institute of Chartered Accountants of Sri Lanka.

(a) Mr Jack of Jack & Jill Associates was in-charge of the new computerized accounting system implementation at Up Hill PLC. Mr. Jack also supervised the parallel run of the new system thereafter. This exercise was concluded on 30 September 2012. The managing director of Up Hill PLC invited Mr. Jack to carry out the audit for the year ended 31 March 2013. (3 marks)

(b) Mrs. Jill is the partner in-charge of the audit of Pure Water Supplies PLC (PWS). PWS has a dispute over the amounts payable to its foreign supplier. Foreign supplier has sent a team of accountants and lawyers to PWS in order to discuss and settle this matter. Mrs. Jill has been invited to lead these discussions on behalf of PWS, since she is more familiar with the financial statements than the finance director of PWS who joined PWS only a few months ago. (3 marks)

(c) Little Star Associates is the external auditor of Twinkle PLC. While carrying out the audit of Twinkle PLC, the audit team discovered certain fraudulent practices in the entity. As a result of these findings, the finance manager and another senior official of the finance division of Twinkle PLC were removed. Since Twinkle PLC was not in a position to find a new finance manager within a short period, the manager in-charge of the audit was offered the position of finance manager by the managing director of Twinkle PLC. (4 marks) (Total 10 Marks)

Question 11

Discuss the following instances with respect to the Code of Ethics for Professional Accountants published by the Institute of Chartered Accountants of Sri Lanka.

(a) Mr. George, a partner of DTG & Company, a firm of practicing chartered accountants, had just completed an assignment on SLFRS implementation at Pubudu Enterprises (Pvt) Limited. The directors of Pubudu Enterprises (Pvt) Limited had requested DTG & Company to carry out the audit of the company with Mr. George as the engagement partner, since he will be able to complete the audit soon. (4 marks)

(b) Mr. John who was the finance manager of ABC PLC up to last year, had joined DTG & Company as a partner recently. The senior partner of the firm had allocated the audit engagement of ABC PLC to Mr. John, as he is well aware of the financial and operational aspects of the entity. (3 marks)

(c) Mr. Dick, another partner of DTG & Company had accepted the annual audit engagement of Big Money Finance PLC. Significant amount of Mr. Dick's personal savings are invested at Big Money Finance PLC. (3 marks) (Total 10 marks)

Question 12

(a) Discuss the following situations in relation to the Code of Ethics of CA Sri Lanka.

(i) Kamal is a Partner of AB Associates, a firm of practicing accountants. The audit of XYZ PLC for the year ended 31 March 2012 was offered to AB Associates. Kamal was a member of the audit committee of XYZ PLC till 31 August 2011. (3 marks)

(ii) Jonson, a partner of AC & Company, a firm of practicing accountants was advising on the new ERP system implementation at Expo PLC. At the end of the same financial year, Jonson was appointed as the Partner in charge of the audit of Expo PLC. (3 marks)

(b) State two (2) instances where practicing accountants may be required to disclose confidential information. (2 marks)

(c) If a member of an assurance team has a direct financial interest in the assurance client, what safeguards are available to eliminate self interest threat? (2 marks) (Total 10 marks)

Question 13

Discuss following situations in relation to the Code of Ethics of CA Sri Lanka.

(a) AB Associates currently carries out the audit of XY Marketing Limited, a subsidiary of XY group of companies. During this year AB Associates was offered the audits of 15 more companies of the XY group. Since the operations of these companies are fairly large, the total audit fee from the group is estimated to be fairly a large portion of AB Associates' total income. (3 marks)

(b) Mr. Kumar, Partner at VV & Company assisted Elite Company (Pvt) Limited in implementing its computerized accounting system during the year. At the end of the year directors of Elite Company (Pvt) Limited invited VV & Company to be auditors of Elite. Since Mr. Kumar is familiar with the systems and procedures of Elite, it was suggested that Mr. Kumar to be the partner-in-charge of the audit of Elite. (3 marks) (Total 6 Marks)

Question 14

Describe the issues in following situations in terms of the Code of Ethics issued by the Institute of Chartered Accountants of Sri Lanka.

(a) Mr. Q Perera who was the finance director of PQR PLC has joined XYZ & Co., a practicing firm, as a partner immediately after resigning from PQR PLC. XYZ & Co. is the auditor of PQR PLC. Mr. Perera was requested to be the partner in charge of the audit for the current year as he is familiar with systems and procedures at PQR PLC. (3 marks)

(b) A letter was received from the stock market regulator requesting PQR PLC to explain certain transactions that were highlighted in the annual report of the company. The financial controller of PQR PLC who is a Chartered Accountant is worried to disclose such information to the regulator as he feels that information relating to the transactions is confidential. (4 marks)

(c) Mr. R R Silva a practicing Chartered Accountant was advising TD Limited in setting up their business operations. The directors of the company had requested Mr. Silva to carry out the first audit of TD Limited. (3 marks) (Total 10 marks)

Question 15

Describe the issues, in following situations, in terms of the Code of Ethics issued by the Institute of Chartered Accountants of Sri Lanka.

(1) XY partners have been the auditor of ABC PLC for the last 2 years and are in the process of negotiating fees for the audit of 31 March 2010. Due to significant rise in costs the auditor is proposing a fee increase of 15%. However, the company is not financially doing well at the moment and is unable to approve such a price increase. XY partners have determined that without a minimum of 15% increase of fee for performing audit services to ABC PLC will not be feasible. ABC PLC is considering appointment of another auditor. (3 marks)

(2) You are the Tax Partner for XYZ PLC and have been advising the client on tax planning strategies for the company. The audit partner of your firm has been fallen ill, and you have been asked to perform the audit for the company as you are familiar with the client. (4 marks)

(3) Perera Partners have recruited a Manager from one of their audit clients Gamma PLC. This employee was the Chief Financial Officer of Gamma PLC, and because of his knowledge of the business he has been assigned for the audit as the manager. (3 marks) (Total 10 marks)



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Quality control

Introduction

SLAuS 220 requires firms to implement quality control procedures over individual audit engagements. An important part of quality control is adequate audit documentation and proper review of that documentation.

Quality control requirements

The requirements concerning quality control on individual audits are found in SLAuS 220 Quality control for an audit of financial statements. Quality control will not be tested in detail in your KB4 examination but the key objectives are set out below.

SLAuS 220.6

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and applicable legal and regulatory requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

Professional standards require adequate audit documentation to be prepared.

The burden of quality control falls on the audit engagement partner, who is responsible for the audit and the ultimate conclusion.

Audit documentation (which we consider in detail in Section 2) must be sufficient to facilitate both audit manager and audit engagement partner reviews.

The audit engagement partner review includes consideration of whether:

- The work has been performed in accordance with professional standards and regulatory and legal requirements
- Significant matters have been raised for further consideration

- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- There is a need to revise the nature, timing and extent of work performed
- The work performed supports the conclusions reached and is appropriately documented
- The evidence obtained is sufficient and appropriate to support the auditor's report
- The objectives of the engagement procedures have been achieved

Before the audit report is issued, the engagement partner must be sure that sufficient and appropriate audit evidence has been obtained to support the audit opinion. The audit engagement partner need not review all audit documentation, but may do so. He should review critical areas of judgement, significant risks and other important matters.



Audit documentation

It is important to document audit work performed in working papers to:

- Enable the reporting partner to ensure all planned work has been adequately completed
- Provide details of work done for future reference
- Assist in planning and control of future audits
- Encourage a methodical approach
- Record any matters arising after the date of the audit report

The objective of audit documentation

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. The term 'working papers' or 'work papers' are also sometimes used.

All audit work must be documented: the working papers are the tangible evidence of the work done in support of the audit opinion. SLAuS 230 *Audit documentation* states that the auditor shall prepare audit documentation on a **timely basis**.

Audit documentation is necessary for the following reasons:

- It provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective.
- It provides evidence that the audit was planned and performed in accordance with SLAuSs and other legal and regulatory requirements.
- It assists the engagement team to plan and perform the audit.
- It assists team members responsible for supervision to direct, supervise and review audit work.
- It enables the team to be accountable for its work.
- It allows a record of matters of continuing significance to be retained.
- It enables the conduct of quality control reviews and inspections (both internal and external).

Significant matters

Significant matters are substantive matters deemed important to the evidence obtained, procedures performed or conclusions reached in the audit.

Significant matters identified in the audit need to be documented in the audit file in accordance with SLAuS 230. Examples of the types of significant matters to be recorded are:

- Matters giving rise to a significant risk
- Results of audit procedures indicating that the financial statements could be materially misstated.
- Results of audit procedures indicating a need to revise the auditor's previous assessment of risks of material misstatement and the auditor's response to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings resulting in a modification to an audit opinion.

The SLAuS provides detail on how significant matters should be documented.

These provisions are provided below.

SLAuS 230.8

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

SLAuS 230.10

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

The SLAuS also provides guidance on the exercise of professional judgement exercised in performing the work and evaluating the results of a significant matter.

SLAuS 230.A9

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment.

Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Form and content of working papers

The SLAuS requires working papers to be sufficiently complete and detailed to provide an overall understanding of the audit. Auditors cannot record everything they consider. Therefore judgement must be used as to the extent of working papers, based on the following general rule:

What would be necessary to provide an experienced auditor, with no previous connection with the audit, with an understanding of the work performed, the results of audit procedures, audit evidence obtained, significant matters arising during the audit and conclusions reached.

The form and content of working papers are affected by matters such as:

- The **size and complexity** of the entity
- The **nature** of the audit procedures to be performed
- The **identified risks** of material misstatement
- The **significance** of the audit evidence obtained
- The nature and extent of **exceptions** identified

- The need to document a **conclusion** or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained
- The audit **methodology and tools** used

Examples of working papers

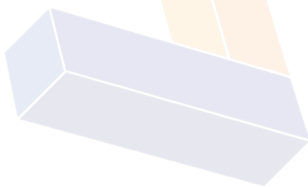
- Information obtained in understanding the entity and its environment, including its internal control, such as the following:
 - Information concerning the legal documents, agreements and minutes
 - Extracts or copies of important legal documents, agreements and minutes
 - Information concerning the industry, economic environment and legislative environment within which the entity operates
 - Extracts from the entity's internal control manual
- Evidence of the planning process including audit programmes and any changes thereto
- Evidence of the auditor's consideration of the work of internal audit and conclusions reached
- Analyses of transactions and balances
- Analyses of significant ratios and trends
- Identified and assessed risks of material misstatements
- A record of the nature, timing, extent and results of audit procedures
- Evidence that the work performed was supervised and reviewed
- An indication as to who performed the audit procedures and when they were performed
- Details of audit procedures applied regarding components whose financial statements are audited by another auditor
- Copies of communications with other auditors, experts and other third parties

- Copies of letters or notes concerning audit matters communicated to or discussed with management or those charged with governance, including the terms of the engagement and significant deficiencies in internal control
- Written representations received from management of the entity
- Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial statements and auditor's reports
- Notes of discussions about significant matters with management and others
- In exceptional circumstances, the reasons for departing from a basic principle or essential procedure of a SLAuS and how the alternative procedure performed achieved the audit objective



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Name of client			Working paper reference
Year-end date	Client: Perera Builders Ltd	Ref: A.1.1	
	Year-end: 30 June 20X7	Prepared by: J Fernando	Preparer
Subject	Subject: Year-end inventory count	Date: 10 July 20X7	Date
Objective of work	<i>Aim</i>		
	<i>Work done</i>	<ul style="list-style-type: none"> - Sample selection including basis - Work done - Source of information - Key to any audit risks - Appropriate cross referencing 	
- Conclusions - Key points	<i>Results</i>	<ul style="list-style-type: none"> - Results - Analysis of errors or other significant observations 	
	<i>Conclusions</i>		
Reviewer	Reviewed by: L Dias		
Date reviewed	Date: 15 July 20X7		



Identifying characteristics

The auditor should record the **identifying characteristics** of specific items or matters being tested. This allows the audit team to be accountable for its work and facilitates the investigation of exceptions and/or inconsistencies. Identifying characteristics will vary with the type of audit procedure and the items being tested.

Examples of identifying characteristics include:

- To test the entity-generated purchase orders, the auditor may identify documents selected for testing by dates and unique purchase order numbers.
- To make inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of personnel.
- To make an observation, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

Firms should have standard **referencing** and **filing** procedures for working papers, to facilitate their review.

Assembly of the audit files

For recurring audits, working papers may be split between:

Permanent audit files (containing information of **continuing importance** to the audit).

These contain:

- Engagement letters
- New client questionnaire
- The memorandum and articles
- Other legal documents, such as prospectuses, leases, sales agreement
- Details of the history of the client's business
- Board minutes of continuing relevance

- Previous years' signed accounts, analytical review and management letters
- Accounting systems notes, previous years' control questionnaires

Current audit files (containing information of relevance to the **current year's audit**).

These should be compiled on a timely basis after the completion of the audit and should be assembled with the following documents

- Financial statements
- Accounts checklists
- Management accounts details
- Reconciliations of management and financial accounts
- A summary of unadjusted errors
- Report to partners including details of significant events and errors
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Representation letter
- Management letter
- Notes of board minutes
- Communications with third parties such as experts or other auditors

The audit files also need to contain working papers covering each audit area.

These should include the following:

- A lead schedule including details of the figures to be included in the accounts
- Problems encountered and conclusions drawn
- Audit programmes
- Risk assessments
- Sampling plans
- Analytical review
- Details of substantive tests and tests of control

If it is necessary to modify/add new audit documentation to a file after it has been assembled, the auditor should document:

- Who made the changes, and when, and by whom they were reviewed
- The reasons for making changes
- The effect of changes on the auditor's conclusions

Matters arising after the audit report

The assembly of the final audit files needs to be completed on a timely basis after the date of the auditor's report. After the final audit file has been completed, the auditor cannot discard or delete any audit documentation before the end of the required retention period.

If, in exceptional circumstances, changes are made to an audit file after the audit report has been signed, the auditor should document:

- The specific reasons for making the changes
- The audit procedures performed, evidence obtained, conclusions drawn
- When and by whom changes to audit documents were made and reviewed

Standardised and automated working papers

The use of **standardised** working papers, for example, checklists and specimen letters, may improve the efficiency of audit work but they can be dangerous because they may lead to auditors mechanically following an approach without using audit judgment.

Automated working paper packages have been developed which can make the documentation of audit work much easier. Such programs aid preparation of working papers, lead schedules, the trial balance and the financial statements themselves. These are automatically cross-referenced, adjusted and balanced by the computer.

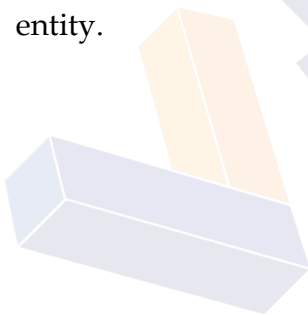
The **advantages** of automated working papers are as follows.

- The risk of errors is reduced.
- The working papers will be neater and easier to review.
- The time saved will be substantial as adjustments can be made easily to all working papers, including those summarising the key analytical information.
- Standard forms do not have to be carried to audit locations.
- Audit working papers can be transmitted for review via a modem or fax facilities.

Safe custody and retention of working papers

Judgement may have to be used in deciding the length of holding working papers, and further consideration should be given to the matter before their destruction. Working papers are the property of the auditors. They are not a substitute for, nor part of, the entity's accounting records.

Auditors must follow ethical guidance on the confidentiality of audit working papers. They may, at their discretion, release parts of, or whole, working papers to the entity, as long as disclosure does not undermine 'the independence or validity of the audit process'. Information should not be made available to third parties without the permission of the entity.



Practice Question

Question 01

You are an audit manager reviewing a working paper produced by a member of the audit team. The working paper is shown below.

Client Name XYZ

Year end **31 December**

Working paper title: **Payables transaction testing**

Prepared by:

Date

Reviewed by:

Date

Audit assertion: To make sure that the purchases in the accounts are correct.

Procedure: Select a sample of 20 purchase orders recorded in the purchase order system and trace details to the goods received note (GRN), purchase invoice (PI) and the purchase day book (PDB). Verify that the quantities and prices recorded on the purchase order are in accordance with those on the GRN, PI and PDB. Trace totals through to the general ledger.

Work carried out: In accordance with audit risk, a sample of purchase orders were selected from a numerically sequenced purchase order system and details traced as stated above.

Results: Details of purchase orders were mostly correctly recorded through the system. A few purchase orders did not have any associated GRN or PI and were not recorded in the PDB. Further investigation showed that these orders had been cancelled due to a change in specification. However, this does not appear to be a system deficiency as the finance director has said internal controls do not allow for changes in specification.

Conclusion: Purchase orders are completely recorded in the purchase day book.

Required

Evaluate the working paper shown above.

Evaluation of working paper

Overall the working paper is not adequate for the purpose of documenting audit evidence obtained over purchases and related liabilities. The reasons for this are as follows.

- (a) The working paper does not state who prepared it, so it makes it difficult for the reviewer to follow-up any queries arising during the review.
- (b) The working paper has not been dated by the person who prepared it.
- (c) The working paper does not include the full year-end date that the audit relates to and could potentially be filed in an incorrect audit file.
- (d) The audit assertion has not correctly been identified and instead a very general objective has been stated. This does not tell the reviewer what this specific procedure is trying to achieve. The test is concerned with completeness of purchases and related liabilities and alone results from this test cannot assert total purchases are 'correct'.
- (e) The working paper does not include the detailed results. There should be adequate details of each of the items tested (purchase orders, related documents and their references/details). Instead there are just general comments about some exceptions found.
- (f) The method of sample selection and number to test has not been clearly explained in the working paper. It simply states that 20 purchase orders were selected, but not the basis for the selection nor how the sample was selected.
- (g) The conclusion reached contradicts the results of the audit work, since anomalies were found in the testing but the conclusion states that purchase orders are completely recorded in the purchase day book. The director's explanation is not adequate since any such internal control does not appear to be operating effectively.
- (h) There is no reference on the working paper so it may not be properly filed and it will not be possible to cross-reference to it.

Question 02

The new partner in charge Sujatha always highlighted the importance of preparing audit documentation that is sufficient in order to enable an experienced auditor having no previous connection with the audit to understand the work performed, and the results of the audit procedures.

Required:

(c) State (04) matters that affect the form and content of working papers of the audit. (4 marks)

Question 03

SLAuS 230 Audit Documentation requires auditors to prepare audit documentation for an audit of financial statements on a timely basis.

Required: Describe FOUR benefits of documenting audit work. (4 marks)



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