

# Section 2

## Ethics & Acceptance

# Potential Issues Before Acceptance



# Appointment & Removal of auditors

Sec 246 CA 2017

## Appointments

### First Auditors

- By Board of Directors within 90 days of incorporation.
- By Commission [SECP] if Company fail to appoint after 90 days.

### Subsequent Auditors

- Appointed Auditors shall hold office until the conclusion of forthcoming AGM.
- Commission may appoint a person if company fails to appoint;
  - First auditors in 90 days
  - Auditor in AGM
  - Auditor due to casual vacancy in 30 days
  - Appointed auditors are unwilling to act.

## Removals

- By Special Resolution of Shareholders

# Who can act as an auditor

## Qualification & Disqualifications of auditors

### ✓ CAN ACT

#### INDIVIDUALS

- A member of a Recognized Supervisory Body e.g. ICAP, and
- Allowed by the rules of that body to be as auditor through a practice license.
- CA – Public Co. & Its subsidiaries
- CA or ACMA – Private Co. if Capital does not Exceed Rs 3 M

#### FIRMS

- Controlled by members of a suitably authorized through a practice license by a supervisory body e.g. ICAP

### ✓ CAN NOT ACT

#### EXCLUDED BY LAW

In Pakistan

- An officer (Director or secretary) of the company
- An employee of the company
- A business partner or employee of the above.

#### EXCLUDED BY ETHICS

- Due to lack of objectivity or independence, for example, due to:
  - Close business relationships
  - Personal relationships
  - Long association with the client
  - Fee dependency
  - Provision of Non audit services

# Persons Disqualified to be auditor of a Company

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- Any person employed at Company in last 3 Years
- Partner, director, officer, employee of a company
- Spouse of a director
- Person indebted to the company  
[**exceptions:** credit card balance of <Rs 1 M, utility bills unpaid upto 90 days.]
- Person who has given a guarantee / security related indebtedness of third party to the company
- Person who has business relationship with the company
- Person who has been convicted by a court of an offence related to fraud and 10 years has not elapsed since conviction.
- Body Corporate
- Person not eligible to act as auditor under Code of Ethics as adopted by ICAP & ICMAP
- Shares of the audit client held by a person, his spouse or minor children, firm & partners.

[**exceptions:** if such person disclose this fact and disinvest such shares with in 90 days of his appointment]

# Rights of Auditor

Auditors have the following rights beside duty to perform audit with due professional care and competence.

Access to books & records

Receive information necessary for audit

Receive notice of AGM & other meetings

# What are Ethics and why these are important?

Moral principles that govern a person's behavior or the conducting of an activity.

It means that a professional accountant should be having strong moral principles so that he can perform audit with strong moral principles.

Ethics for auditors were always very important but the financial scandals in the last two decades has made it essential requirement for the auditors. Lets have a look on a major scandal happened in Enron in Year 2000.

# Enron's Scandal – What Happened to Enron

Enron Incorporation – a US energy company, bankrupted and as a result the share price fall to less than **0.75** Dollar (Nov 2001) from **90.75** Dollar (Jun 2000).

Management of the Enron was charged for multiple financial crimes e.g. making false statements to auditors/banks, hiding of losses / illegal investments etc.

Arthur Anderson – One of big 5 accounting firms were the auditors of the Enron and were failed to cooperate with the investigations and found guilty for shredding the thousands of documents and deleting e-mails and company files.

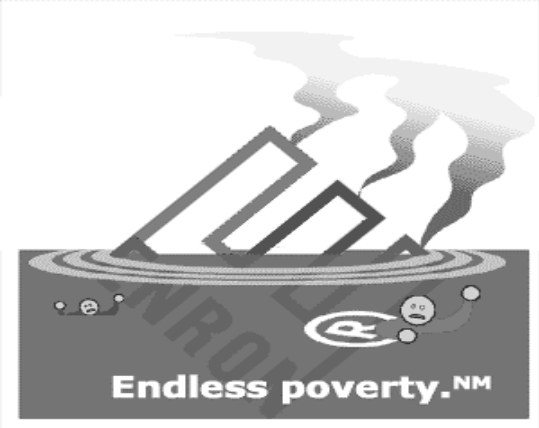


# Major Financial Scandal and its ramifications

**BEFORE**



**AFTER**



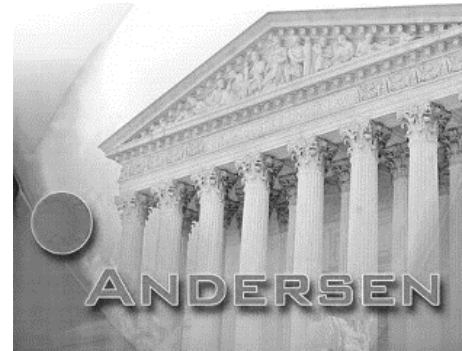
# Parties to Scandals

## MANAGEMENT OF



**Demonstrated Lack  
of Good Governance**

## AUDITORS



**Demonstrated Lack of  
Professional Ethics**

# Road to Ethics



Fundamental Principles

Threats

Safeguards

# ICAP Code of Ethics

# 2015 Edition

ICAP has a tradition to adopt code of ethics developed by  
IFAC –  
International Federation of Accountants.

Latest available Code of Ethics Handbook adopted by ICAP  
in 2015 which is part of our syllabus.

# Ethics – Fundamentals Principles



# Fundamental Principles Explained

## Integrity

To be straight forward and honest in relationships.

## Objectivity

To not allow bias, conflict of interest & undue influence over professional judgement.

## Professional Competence & Due Care

To maintain professional knowledge / skill & act diligently.

## Confidentiality

To respect the confidentiality of the information unless it is a professional duty or right.

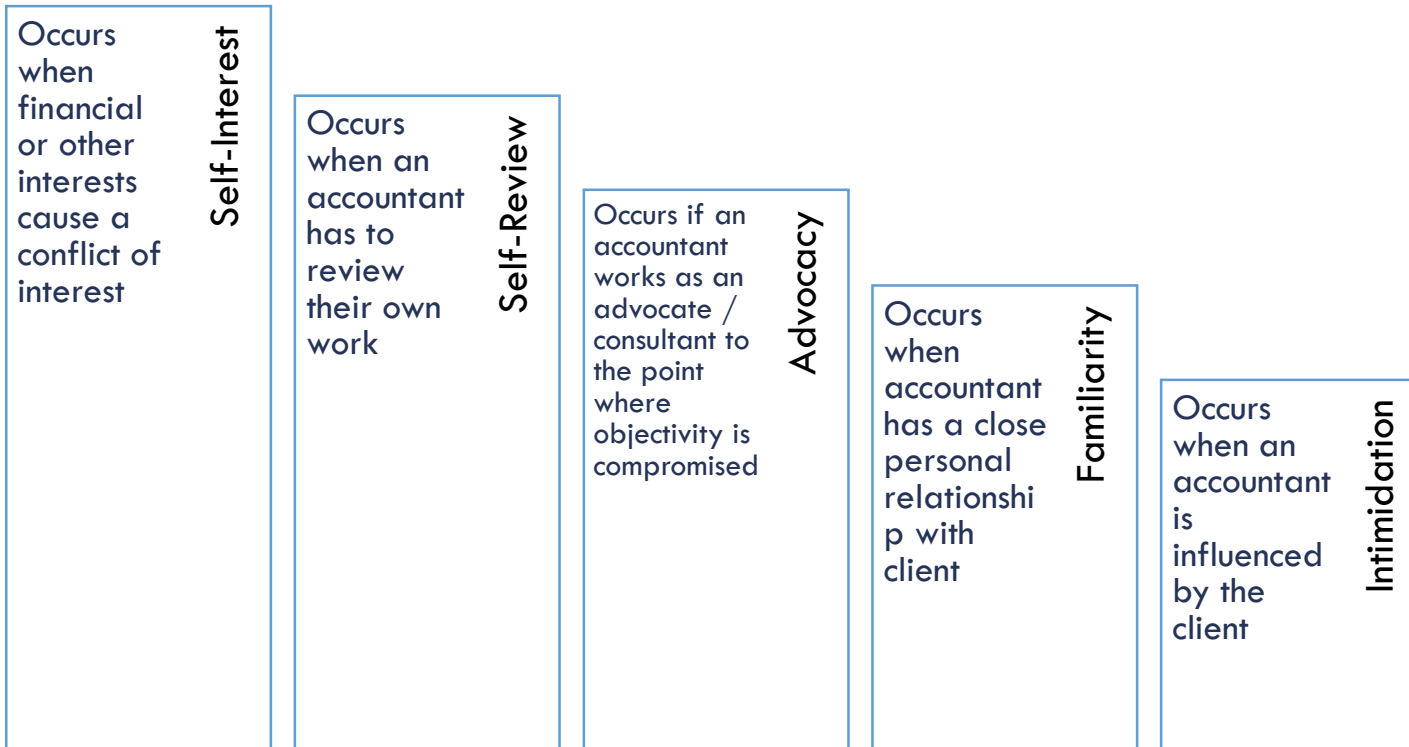
## Professional Behavior

To comply with laws / regulations & avoid any action that discredits the profession.

# Ethics – Threats



# Ethics – Threats





# Examples of Self Interest Threat

1. Member having direct financial interest.
2. Fee dependency on a client.
3. Close business relationship with client.
4. Fear of Losing client.
5. Employment opportunity at client.
6. Contingent fee.
7. Discovery of error in service provided by other members in the firm.

## Examples of Self Review Threat

1. Non-assurance services performed by the firm.
2. Data compilation by the firm.
3. Member was recently director or officer of the client.
4. Member was recently employee dealing with Reporting etc.
5. Member performing any service related to subject matter.

## Examples of Advocacy Threat

1. The firm promoting shares in an audit client.
2. Acting as an advocate on behalf of an audit client.
3. Any other service as an advocate.

## Examples of Familiarity Threat

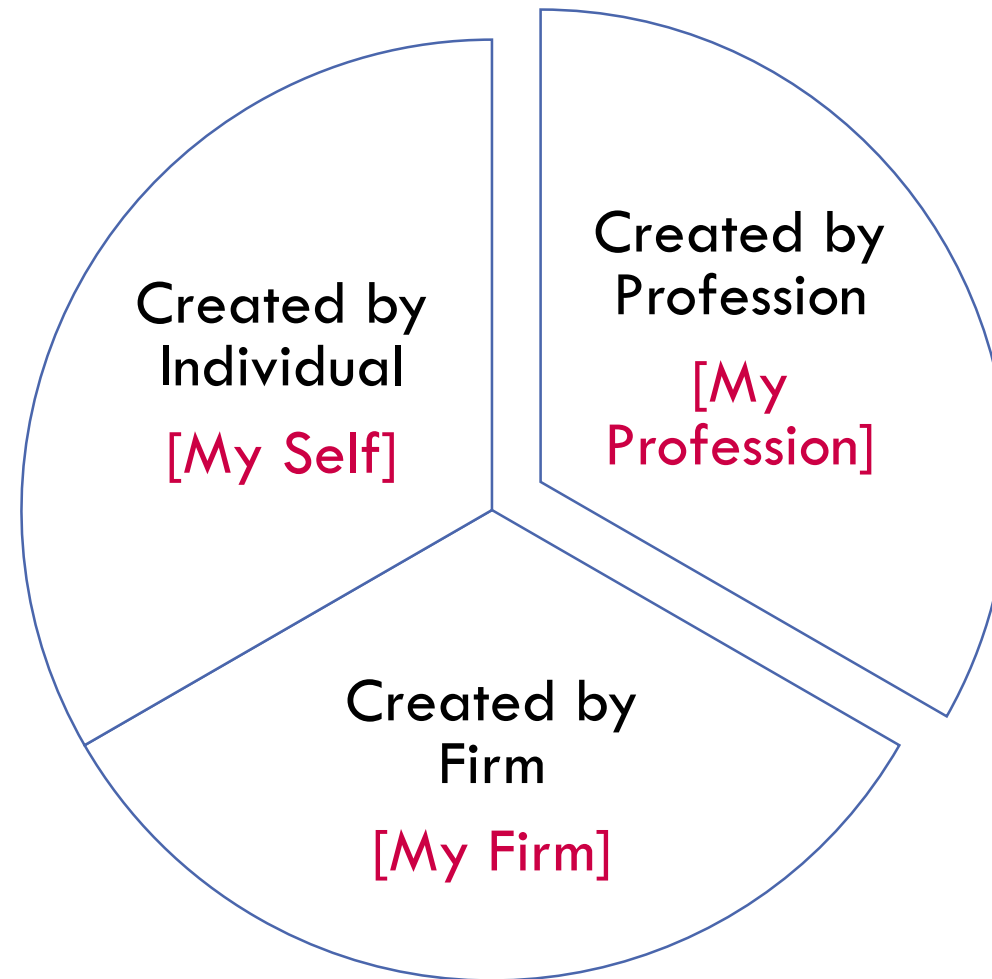
1. Close family member is director/officer at client.
2. Close family member is a key employee at a client.
3. A director/officer/an employee at client was previously partner/manager in firm.
4. Accepting gifts or preferential treatment from client, except the value is trivial or inconsequential.
5. Senior personnel having a long association with the client.

## Examples of Intimidation Threat

1. Fear of dismissal by the client.
2. Fear of not getting non-audit services
3. Threat of litigation by the client
4. Pressure of reducing work and fees
5. Pressure to agree with client employee as he has more expertise
6. Fear of losing promotion in the firm if the client's desired inappropriate treatment is not agreed.

# Ethics – Safeguards

3 MYs



# Accepting New Audit Engagements

New Audit can either be obtained by **Tender or Referral**

**If offered audit the auditor must:**

- Communicate with outgoing auditors
- Follow Legal requirements of Removal & Appointment
- Check independence.
- Assess risk
- Apply 'Know Your Client – KYC' procedures
- Issue engagement letter

# Advertising and Publicity – Code of Ethics

Professional bodies normally allow members to seek publicity for their services and to advertise their services. However, whatever medium is used, it **must not reflect badly on the member, the member body or the accountancy profession.**

Members must also take care that the way in which they market their services does not create a **self interest threat** to the fundamental principle of **professional behavior.**

As per codes advertisements and promotional material must not:

- discredit the services offered by others (for example by claiming superiority);
- be misleading; or
- fall short of any local regulations etc.



# Advertising and Publicity – Code of Ethics

- **Undue publicity to be avoided**
  - use means which bring the profession into disrepute;
  - make exaggerated claims for the services, qualifications, or experience; and
  - Denigrate (Defame/Belittle) the work of other accountants.
  
- **Advertising for solicitation must be avoided**
  
- **Careful mentioning of Fee**
  
- **Disclosure of referral fee for Introductions**
  
- **Participation in tendering process**

## Pre Conditions for an Audit

1. Establish if the financial reporting framework (IFRS) to be used in the preparation of the financial statements is **acceptable**, and
2. Obtain the agreement of management that it acknowledges & understands its responsibility.
  - a. Responsibility for Financial Statements
  - b. Responsibility for Internal Controls
  - c. Responsibility for Providing Information to Auditor

# Interim Vs Final Audit

Audit fieldwork is sometime performed in two phases:

**Interim audit** – this is performed before the end of the accounting period and may include:

- Discussions with staff and management designed to enhance the auditor's understanding of the entity and the environment. This will enable the auditor to more fully plan the audit and hopefully reduce the work performed at year end;
- Recording information about the internal control systems that are relevant to the audit;
- Performing some preliminary controls testing or substantive procedures

**Final audit** – this is performed after the year-end when the draft financial statements are available and include full-year balances.

# Engagement Letter

Having accepted an appointment as auditor of a client, the audit firm should submit an engagement letter to the board of directors of the client company. The engagement letter can be seen as the basis for the contract between the company and the auditor.

The content of the engagement letter:

## *EL should Include:*

- The objective and scope of the audit.
- The responsibilities of the auditor.
- The responsibilities of management.
- Identification of the underlying financial reporting framework.
- Reference to the expected form and content of any reports to be issued.

## *EL may Include:*

- the fact there is an unavoidable risk that some material misstatements may not be detected;
- arrangements for planning and performance of the audit, including the composition of the audit team;
- the expectation that management will provide written representations;
- the basis on which fees are computed;
- a request for management to acknowledge the engagement letter and to agree to its terms;

# What is fraud?

**Misstatement** in financial statements can arise from either *fraud* or *error*.

The distinguishing factor is whether action that resulted in the misstatement was *intentional* or *unintentional*.

**Fraud** – an intentional act by any one involving the deception to obtain an unjust, or illegal advantage.

Fraud can be either Fraudulent Financial Reporting or Misappropriation of Assets.

# Fraudulent financial reporting & Misappropriation of assets

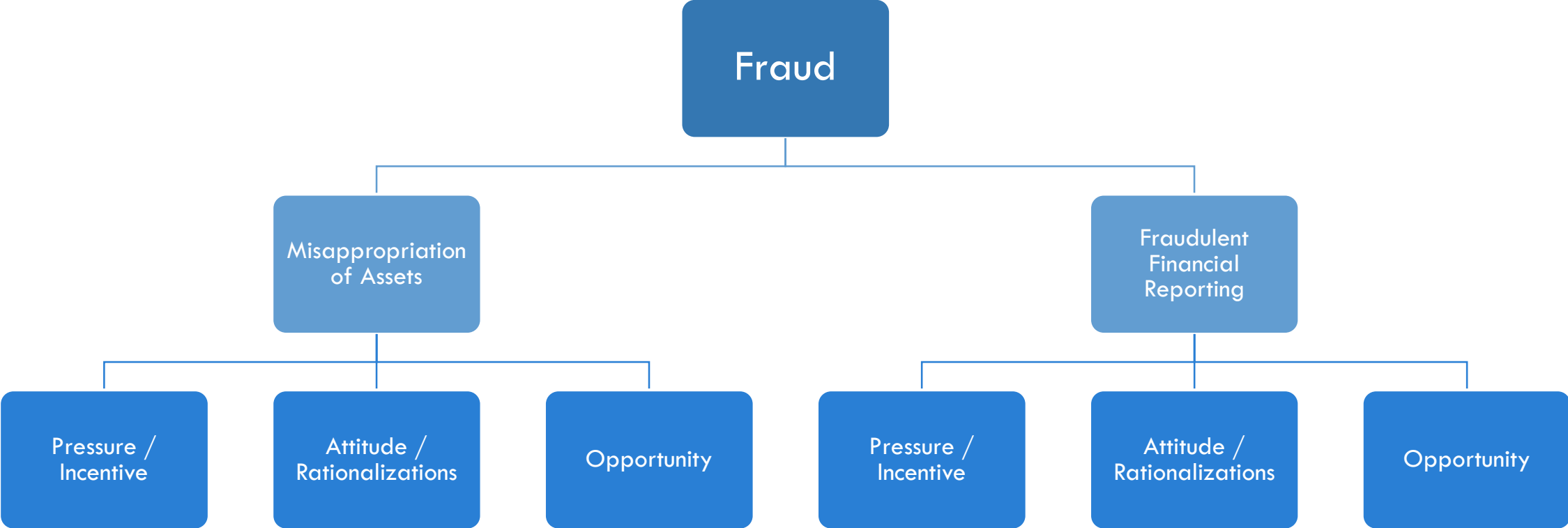
**Fraudulent financial reporting** - involves intentional misstatements, including omissions of amounts or disclosures in the financial statements, to deceive financial statement users.

**Misappropriation of assets** – involves the theft entity's assets by anyone including the employees and management in ways that are difficult to detect.

# Fraud Triangle



# Reasons & Forms of fraud





# Fraud Risk Factors

**Fraud Risk Factors** – Events and conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

## Pressure / Incentives

Pressure or incentive to commit fraud may exist when management is under pressure to achieve an expected but perhaps unrealistic target.

## Attitude / Rationalizations

Individual may be able to rationalize (justify) committing a fraudulent act.

Individual possess an attitude that allow him knowingly and intentionally to commit a dishonest act.

## Opportunities

A perceived opportunity to commit fraud may exist when an individual believes internal control can be bypassed.

# Fraud Risk Factors

FRFs related to MM arising from FFR

- **Incentives / Pressures**
  - Availability of bonus on profitability
  - Profitability is threatened by economic conditions
- **Attitudes / Rationalizations**
  - Excessive Interest by Management in increasing earnings and share prices
- **Opportunities**
  - Use of estimates in preparation of Financial Statements

FRFs related to MM arising from MoA

- **Incentives / Pressures**
  - Anticipated future lay off
- **Attitudes / Rationalizations**
  - Tolerance of Petty theft
- **Opportunities**
  - Large of amounts of cash on hand

# Quick Revision – Topics Covered

1. Potential issues before acceptance of an audit
2. Appointment & Removal of Auditors
3. Who can & cannot act as an auditor
4. Persons disqualified as auditor
5. Rights of auditor
6. Ethics – its importance, Enron and other scandals and their ramifications
7. Ethics – principles – threats & safeguards
8. Acceptance of a new audit
9. Advertising and publicity
10. Pre-conditions
11. Engagement letter
12. Interim Vs Final Audit
13. What is fraud
14. Fraud risk factors
15. Practiced 1 MBQs & 5 SBQs