

Series of Webinars organized by Chamber of Tax Consultants

Engagement Management – General Principles and Responsibilities

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Setting the context....to begin with....

- **Challenges faced by the Statutory Auditors**
- **Huge Expectation Gap**
- **Stringent Regulations**
- **Tougher Regulator**
- **Stricter Penal Consequences for breach of duty of care OR negligence**
- **Occurrences of Resignations by auditors in midst of their tenure**
- **Heightened expectations as evident in first AQR carried by NFRA**
- **MCA consultation paper on audit threats – 7/2/2020**
- **Importance of SA's and appropriate documentation**

Agenda....

Engagement Management – General Principles and Responsibilities

- Executing the terms of assignment - Letter of Engagement (LoE)
- Responsibility pertaining to Fraud
- QC for audit of FS
- Documentation

Relevant SA's

- SA 210 – Agreeing the terms of Audit Engagements
- SA 240 - The Auditor's Responsibilities relating to fraud in an Audit of FS
- SA 220 - Quality Control for an Audit of FS
- SA 230 – Audit Documentation

Assurance

	Auditing		Related Services	
Nature of Service	Audit	Review	Agreed upon Procedures	Compilation
Comparative level of Assurance provided by the auditor	High, but not absolute assurance (Reasonable)	Moderate Assurance (Limited)	No Assurance	No Assurance
Governed by	SA's	SRE's	SAE's	SRS's
Report Provided	Positive Assurance on assertion(s)	Negative Assurance on assertion(s)	Factual findings of procedures	Identification of information compiled

SAs can be bifurcated under the following broad heads:

Preliminary Engagement Activities & Planning

SA 200 - Overall Objective of the Independent Auditor and the conduct of an audit in accordance with standards on auditing

SA 210 – Terms of Audit Engagement

SA 220 – Quality Control for Audits of Historical Financial Information

SA 300 - Planning an Audit of Financial Statements

SA 299 - Responsibility of Joint Auditors

SA 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

Execution

SA 320 - Audit Materiality

SA 250 - Consideration of laws and regulations in an audit of FS

SA 330 - Auditor's Response to Assessed Risks

SA 510 - Initial Audit Engagements : Opening Balances

SA 505 - External Confirmations

SAs can be bifurcated under the following broad heads:

Execution (Contd..)

SA 610 - Using the Work of Internal Auditors

SA 520 - Analytical Procedures

SA 530 - Sampling & Other Means of Testing

SA 450 – Evaluation of Material Misstatement Identified during the Audit

SA 620 - Using the Work of an Auditor's Expert

SA 550 - Related Parties

SA 560 - Subsequent Events

SA 240 - The auditor's responsibility relating to fraud in an audit

SA 402 - Audit Considerations Relating to an Entity Using Service Organisation

SA 500 - Audit Evidence

SA 501 - Audit Evidence-specific considerations for selected items

SA 540 - Auditing accounting estimates, including fair value accounting estimates & Related Disclosures

SA 570 - Going Concern

SA 600 - Using The Work Of Another Auditor

SA 230 - Documentation

SA 260 - Communication to Those Charged with Governance

SA 265 - Communicating deficiencies in internal control to Those Charged with Governance

SA 580 - Written Representations

SAs can be bifurcated under the following broad heads:

Reporting

SA 700 - Forming an Opinion and Reporting on Financial Statements

SA 705 - Modifications to the Opinion in the Independent Auditor's Report

SA 706 - Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

SA 710 - Comparative Information—Corresponding Figures and Comparative Financial Statements

SA 720 - The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited FS

Others

SA 800 - Special Considerations : Audits of FS Prepared in Accordance with Special Purpose Frameworks

SA 805 - Special Considerations : Audits of Single Purpose Financial Statements and Specific Elements,
Accounts or Items of a FS

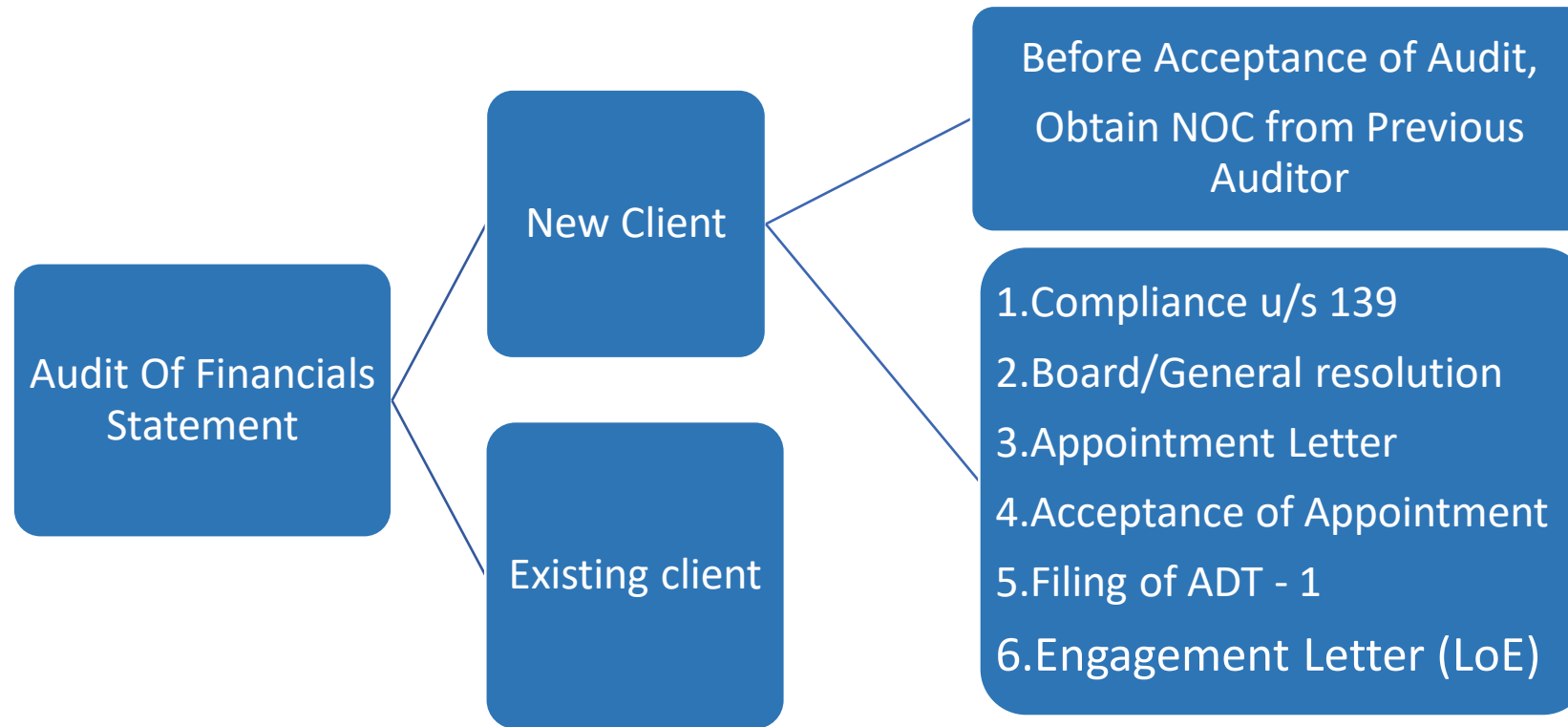
SA 810 - Engagements To Report On Summary FS

SA 200 - Overall Objective of Independent Auditor

SA	Description
SA 200 - Overall Objective of the Independent Auditor and the conduct of an audit in accordance with standards on auditing	<u>Overall Objective of the Independent Auditor-</u> To obtain reasonable assurance that FS are free from Material misstatement due to fraud or error to form an express an opinion that the FS are complying with the applicable FRF in all material respect and to give audit report in accordance with Standards on Auditing and other statutory requirements
	<u>Expectation from Auditor:</u> 1. Ethical Requirements 2. Profession skepticism 3. Professional judgement 4. Sufficient and Appropriate Audit Evidence (SAAE) 5. Compliance with SAs

Engagement related matters

Audit Engagement - Client Acceptance



The LoE in, pre-conditions for an audit, refers to document containing terms of the engagement and role/responsibilities of auditors and auditee.

SA 210 – Agreeing the terms of Audit Engagements

SA	Description
SA 210 - Agreeing upon the terms of Audit Engagement	Auditor should ensure where precondition for an audit exists, there is clear understanding between the auditor and auditee.
Draft template of LoE available on website of ICAI (https://www.icaai.org/post.html?post id=11197)	Where any restriction on scope of audit is imposed by management which impairs the ability of auditor to express opinion, he should not accept the appointment unless it is compulsory under some law or regulation.
Also drafts/templates are contained in Appendix 1 to SA 210	An Audit Engagement Letter is to be sent by the auditor to auditee specifying the terms and conditions of acceptance of audit including roles and responsibilities of auditor and management.
Precondition for an audit: The use by management of an acceptable FRF in preparation of FS on which audit is conducted	As good Governance practice, LoE need to be placed to TCWG

Requirements	Description
Preconditions for an Audit:	• Determine whether the FRF to be applied in the preparation of the FS is acceptable; (para A2 to A9 of SA 210)
Para 6 of SA 210	• Obtain the agreement of management that it acknowledges and understands its responsibilities: ○ For the preparation of the FS in accordance with the applicable FRF, including where relevant their fair presentation; ○ For such internal control as management determines is necessary to enable the preparation of FS that are free from MM, whether due to fraud or error; and ○ To provide the auditor with access to all relevant information, additional information and unrestricted access to persons within the entity.
	cont'd

Requirements	Description
Preconditions for an Audit (contd..)	• If the above-mentioned preconditions are not present, the auditor shall discuss the matter with management. • Unless required by L&R to do so, the auditor shall not accept the proposed audit engagement.
Agreement on Audit Engagement Terms	The executed LoE to include following matters: • Objective and Scope of the Audit • Responsibilities of Auditor • Responsibilities of Management • Identifying applicable FRF • Referring to Form and Content of Report/ Deliverables • Legal or Regulatory Framework, if any, applicable to entity
Recurring Audits	• In case of recurring audits, auditor to assess if circumstances require revision in LoE and/or Need to remind the entity regarding existing LoE

Requirements	Description
LoE also to include	• mention of all services sought by auditee and agreed to be provided • Compliances with the provisions of Section 144 or other conflicts etc and approval of AC or BoD or TCWG • Mention about professional scepticism • Basis on which fees/ billing determined
Other Requirements	• If there are any conflicts between the financial reporting standards and the additional requirements prescribed by L&R: i. Discuss with management the additional requirements, and ii. Agree whether: ○ Additional requirements can be met through additional disclosures in the FS; OR ○ Description of applicable FRF in FS can be amended accordingly. ○ If neither possible, consider effect on audit opinion in accordance with SAs of series 700....

Agreeing Terms of Engagement Letter (LoE) contd..

Also advisable to consider following:

Auditors responsibility to include matters pertaining to:

- Compliance or lack of laws and regulations applicable to the core operations of the company and other such matters which come to notice in course of audit.
- Audit opinion to be defined as providing reasonable assurance and not absolute assurance
- Detection of fraud not being prime responsibility but if noticed during ordinary course, responsibility of reporting
- EP responsibility be identified appropriately and its complying with Quality control policies
- Process of Rotation of engagement partners in view of familiarity threat to be in place.
- Maintenance of confidentiality of information accessed by auditors

Agreeing Terms of Engagement Letter (LoE) contd..

Also advisable to consider following:

➤ **Management Responsibility to include matters pertaining to:**

- Providing full access to required information and personnel during course of Audit
- Providing any information pertaining to whistle blower complains, prima facie found to be inquired into by the Company and all the notices/claims etc received by the auditee
- Providing written representations

➤ **Others:**

- If auditee has subsidiaries/ components which are consolidated with it and which are not audited by the same auditor, reference of parent auditor's communications and power to seek information from component auditors and/or the components.

Agreeing Terms of Engagement Letter (LoE)

Frequent deviations observed:

- LoE not executed/ not documented/ signed by the client around the date of audit report
- Management Responsibility not defined precisely
- Setting up controls and systems to prevent frauds and errors in FS is responsibility of management
- Not issuing separate LoE for engagements other than assurance
- Not addressing LoE to those in charge with governance
- Not referring to financial reporting framework and applicable L&R
- Specifying about Engagement Partner (EP)/ Team and is desirable
- Role of EP and Corresponding EQCR Partner not specifically elaborated
- Consequences in relation to breach/ failure/ wrong-doing

Agreeing Terms of Engagement Letter (LoE)

Suggested format and structure of LoE for statutory audit:

- General or preliminary paragraph describing parties to LoE, period etc
- Scope of work/elements of deliverables - as statutory auditors
- Reporting u/s 143(3)(i) - ICFR
- Basic objectives of audit generally or w.r.t. legal/regulatory framework
- Brief description of the framework applicable to the audit
- Responsibilities of auditors
- Responsibilities of Management
- In case of Joint Audit – reference to the arrangement under SA 299
- Rights/responsibilities of parties in case of components not audited – used in CFS
- Description of limitations, if any, on the scope of audit and its impact
- Fees and Billing – methodology etc
- Maintenance of Confidentiality of information accessed in course of audit
- Other services, if any, and methodology, approvals etc
- Audit Firm expected not to sub-contract or assign any of its work
- Consequences, rights/responsibilities of default, breaches or wrong-doings, if any
- Jurisdiction

SA 220- Quality Control for an Audit of Financial Statements

SA	Description
SA 220- Quality Control for an Audit of Financial Statements	QC System & Role of Engagement Team <u>Responsibility of Audit Firm:</u> ➤ Implement QC system that provides reasonable assurance: • Firm & its personnel comply with professional standards & regulatory & legal requirements. • Reports issued by firm/ engagement partners are appropriate in the circumstances. <u>Responsibility of Engagement Team:</u> • Implement applicable QC procedures. • Provide firm with relevant info wrt QC re Independence

SA	Description
SA 220- Quality Control for an Audit of Financial Statements	<u>Leadership Responsibilities for Quality in Audits:</u> ➤ Auditor to emphasize to engagement team importance of: • Compliance with professional Standards, L&R. • Compliance with firm's applicable QC policies. • Issuance of appropriate audit report. • Ability to raise concerns without fear. • Quality is quintessential & indispensable in engagement performance

SA 240 - The auditor's responsibility relating to fraud in an audit

SA	Description
SA 240 - The auditor's responsibility relating to fraud in an audit. <u>For purpose of this SA:</u> Fraud – an intentional act of deception by one/more individuals, among mgmt., TCWG, employees, third parties to obtain an unjust or illegal advantage. Fraud Risk Factor – events or conditions that indicate an incentive or pressure or opportunity to commit fraud	<u>Duties of Auditor</u> <u>Part A</u> ➤ Identify and assess risk of material misstatement due to fraud ➤ Understanding entity's business ➤ Enquire with management regarding • Management's assessment of risk of material misstatement (ROMM) • Management findings ➤ Enquiry with Internal Auditor, if any ➤ Applying Analytical Procedures <u>Part B</u> ➤ Overall Response to Assessed Risk ➤ Response at assertion level • Check appropriateness of accounting entries • Review Accounting Estimates

SA	Description
SA 240 - The auditor's responsibility relating to fraud in an audit	<u>Fraud Suspected</u> ➤ Perform further audit procedures unless fraud is either confirmed or dispel ➤ If the auditor is unable to detect fraud due to restriction on scope of Audit and if the matter is material and pervasive, the auditor to consider issuing disclaimer of opinion. ➤ If there is no basis to issue disclaimer, he shall withdraw from the engagement
	<u>Fraud Detected</u> ➤ If material - reassess the risk of material assessment and adjust substantive procedures if required. Communicate to TCWG and Management and if required disclose in FS. ➤ If immaterial- then the list of uncorrected misstatements should be updated.

SA	Description
SA 240 - The auditor's responsibility relating to fraud in an audit	Auditors' ability to detect fraud depends on many factors, e.g. • Skillfulness of perpetrator • Frequency/extent of manipulation • Degree of collusion between wrong-doers • Seniority of personnel involved • Auditors agility and questioning skills
'Fraud' being broad legal concept, for the purpose of reporting, Auditor to consider frauds that cause material misstatement in FS, without making legal determination as to whether the fraud has actually occurred (para A1 to A6 of SA 240).	➤ Appendix 1 contains numerous examples of fraud risk factors – which auditor needs to carefully consider while deciding audit strategies ➤ Appendix 2 lists out examples of possible audit procedures to address the assessed risk of material misstatement in FS due to fraud ➤ Appendix 3 contains examples of circumstances that indicate the possibility of Fraud

Fraud Detection & Audit – Summary of Legal background

As early as in 1896 – the famous case of “Kingston Cotton Mills” laid down some fundamental auditing principles such as ‘watchdog’ role as also notion of taking reasonable skill & care.

It said an auditor is not bound to be a detective or to approach his work with suspicion that there is something wrong. If there is anything calculated to excite suspicion, it should be probed to the bottom; but in absence of any indication thereof, auditor is bound to be reasonably cautious and careful.

Royal Commission laid down obligation on auditors in HIH Insurance case (2005) - *“auditors have an obligation to ensure that they are, and are seen to be, maintaining high standards of honesty and probity, acting in the interests of the shareholders of the company and exercising independence of mind.”*

In 1895, London & General Bank case also enunciated principle of ‘duty of care’ and to provide an information and not means to an information

The narrow interpretation of Kingstone Cotton Mills case was put to some test in the Pacific Acceptance case (1970), which noticed the changing expectations from Auditors and Standard of reasonable care also being raised.

Thus, Reasonable skill and care’ call for changed improved standards requiring a learned professional to undertake the same with professional scepticism.

Fraud Detection & Audit – Summary of Legal background

There have been major changes, world over, in the legal environment concerning auditor's liability over last several decades. The gigantic growth of business enterprises, ever growing separation of ownership and management, structuring of global businesses, end-to-end use of technology in business processes hardly leaving any audit trail and growing complexities necessitated most of the changed legal or standards environment with heightened expectations from Audit Professionals.

Numerous cases on charges of 'negligence' on auditors world over form the basis of today's auditing literature of 'professional diligence' and 'duty of care' as also requirement for evidencing the audit process through appropriate documentation.

Recently, SEBI Appellate Tribunal (SAT) reversed most part of SEBI's order for banning an audit firm for two years in case of Satyam Computers. Whilst, SAT upheld the disgorgement penalties levied by SEBI on the audit firm for its negligence, it quashed the SEBI order banning the firm from auditing other listed companies/entities regulated by SEBI. In a way, SAT order echoes the dictum of century old case of Kingston Cotton Mills and states that auditor is required to employ reasonable skill and care unless there are reasons evident of any fraud or wrongdoings. The order of SEBI, according to SAT, fails to prove the 'mens rea' on part of the partners/Firm and on facts of the case, banning the firm from auditing other Companies is held to be not within SEBI's jurisdiction.

Legal Framework – Fraud Reporting

1. Companies Act, 2013 ('The Act')

- Definition of Fraud - Explanation to Section 447 of the Act
- Provisions for penalty and consequences of fraud under the Act for Company and Auditors as well.
e.g. Sections 7(5), 7(6), 8(11), 34, 36, 38(1), 46(5), 56(7), 66(10), 75, 140(5), 206(4), 213, 229, 251(1), 266(1), 339(3), 448.
- NCLT powers to change auditors under section 140(5) of the Act.
- Provisions of Section 447 extends to any misleading statement in the offer document or prospectus (Section 35).
- Reporting requirements of fraud unearthed by auditors in course of audit applies to:
 - Section 143(12) – for Auditor
 - Section 148 – for Cost Accountant
 - Section 204 – for Company Secretary

Legal Framework – Fraud Reporting

1. Companies Act, 2013 ('The Act')

- Section 143(12) of the Act – duty of auditor for reporting fraud

<u>Amount involved</u>	<u>Reporting to BOD/AC</u>	<u>Response from BOD/AC</u>
>=Rs. 1 cr.	Immediately Not later than 2 days	within 45 days
< Rs. 1 cr.	Within 2 days	Not mentioned

- Guidance Note on reporting on Fraud under section 143(12) of the Act by ICAI.
- Punishment to auditors for contravention of provisions of section 143(12) under Section 147(2)
- Companies (Auditors Report) Order, 2016 ('CARO') Reporting along with ICAI GN on CARO 2016.

Legal Framework – Fraud Reporting

2. Bank Audit

- RBI Circular No. DBS.FGV. (F).No.BC/23.08.001/2001-02 dated May 3, 2002
- Master Circular no. DBS.CO.CFMC.BC.No. 1/23.04.001/2015-16 dated July 1, 2015

3. The Chartered Accountants Act, 1949

- Penal provisions for 'professional misconduct', 'negligence' and lack of 'duty of care' by Chartered Accountants
- Clauses of Second Schedule being relevant for failure to detect/ report fraud:
 - Clause (5): failure to disclose material fact known to Auditor
 - Clause (6): failure to disclose material misstatement in FS
 - Clause (7): failure to exercise due diligence in conduct of professional duties
 - Clause (8): failure to obtain sufficient information for expression of opinion

Some thoughts on Fraud Detection

In India, recently we are witnessing troubled scenarios in the corporate field. Several business failures, scams, bank frauds, auditors' resignations, regulatory activism, emergence of new auditing regulator (NFRA) etc. makes the situation 'never seen before' scenario. Therefore, issues pertaining to auditor's role and responsibility assume paramount importance to the profession and society at large

Therefore:

- Professional scepticism should be instilled deeply in auditors' way of functioning
 - Questioning mindset, number crunching abilities and critical analytical approach needed
 - Stringent scrutiny of design and effectiveness of Internal control systems of the auditee
 - Internal Control over Financial Reporting- not just 'check-list' filling exercise
 - Governance practices, overall surrounding and quality of personnel need to be considered
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Some thoughts on Fraud Detection (contd..)

- Identify things or situations that appear 'too good to be true' and probe them
 - Extract 'exception reports' from auditee's operating systems for qualitative checks
 - Leveraging technology by use of CAATs or other means
 - Do not ignore things which appear too simple
 - Analytical and pattern studies often provide useful hints
 - Interaction with not-so-senior personnel of the auditee
 - Element of surprise in verification, visits and checking
 - Do not let audit processes and plans be predictable
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Suggestive actionables for implementing SA 240 1/3

- Maintaining Independence
 - Discussion among the team members and Engagement partner on focus areas
 - Make enquiries of Management in terms of assessment, identification and response to risk of fraud.
 - Make enquiries of internal audit and to obtain its views and risk about the fraud.
 - Understand how those charged with governance:
 - exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity
 - Identify the internal control that management has established to mitigate these risks.
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Suggestive actionables for implementing SA 240 2/3

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- Evaluation of unusual or unexpected relationships identified in performing analytical procedures indicating ROMM.
 - Identifying and assessing the ROMM due to fraud at the:
 - FS Level
 - Assertion level for classes of transactions, account balances and disclosures
 - Determine overall responses to address the assessed ROMM due to fraud at the FS level.
 - Design and perform audit procedures to test the appropriateness of journal entries and other adjustments made in the preparation of financial statements.
 - Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a ROMM due to fraud.
 - In case of significant transactions outside the normal course of business, evaluate whether the business rationale (or the lack thereof) of the transactions.
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- If the auditor identifies a misstatement and has reason to believe that may be the result of fraud and involvement of management, he shall re-evaluate the assessment of the ROMM due to fraud and its resulting impact on the NTE of audit procedures.
 - Evaluate the implications for the audit where auditor confirms or is unable to conclude whether the financial statements are materially misstated as a result of fraud.
 - Communicate matters identified as indicative of Fraud on a timely basis to the appropriate level of management for the prevention and detection of fraud.
 - If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the NTE of audit procedures.
 - The auditor's legal responsibilities override the duty of confidentiality in some circumstances.
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Minimum Documents Requirements in suspect cases

- Paragraph 106 of Guidance note on reporting on Fraud under section 143(12) of the Companies Act, 2013 requires auditors to maintain as part of the audit documentation:
 - Minutes of Inquiry,
 - Fraud risk factor,
 - Copy of correspondence,
 - Management response,
 - Memo documenting Professional Judgment and
 - Additional audit procedures carried out
 - Paragraph 58 of the Guidance note requires that Auditor should consider Para A-19, A-20 and 28 of SA 250 where fraud is consequent to corruption, bribery and money laundering and noncompliance with other laws and Regulations.
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SA 230 - Audit Documentation

SA	Description
SA 230 - Audit Documentation	As per SQC 1, retention period of working papers should not be less than 7 years from the date of Auditor's report (or Group Auditor's report, if applicable) Working papers are the property of auditor and it is at his discretion to make copies or extracts of Working Papers available to the client However, sharing working papers with others must be with the discretion of the auditor along with client's permission so that confidentiality can be maintained

SA	Description
SA 230 - Audit Documentation	Audit documentation is the record of audit procedure performed, audit evidence obtained and the conclusion that auditor has reached. Working papers of an auditor can be physical or electronic. <u>Modification of Working Papers-</u> No modification is to be done to the working papers once Audit Report has been issued except where compliance with SA 560 is required.

What, where, how and how much to document???

Suggested optimum Documentation

Audit documentation may be recorded on paper or on electronic or other media.

Suggestive Documentation of audit process:

- Planning
- Risks identification
- Determination of responses to identified risks
- Verification
- Control testing
- Use of sampling techniques
- Third party confirmations
- Analytical procedures
- Trend and business analysis
- Minuted interactions with audit personnel
- Asking Queries and seeking replies
- Consultations
- Conclusions

Examples:

- Audit programmes
- Analysis or Overall Analytical Review File
- Issues memoranda
- Summaries of significant matters
- Letters of confirmation and representation
- Checklists
- Correspondence (including e-mail) concerning significant matters
- Consultation Memoranda (in case of any consultation or interpretational matters)

Thank You!!

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