Professional Ethics and Codes of Conduct

Ethics are about what is morally wrong or right. It is not a legal requirement but it is advisable to follow. Why?

- It increased the user confidence that the auditor is functioning according to a code of ethics.
- The auditor need the code of ethics to make sure that he is worthy of level of trust.
- Uphold the level and quality of work performed.
- The rules deter from misconduct and departure from ethical codes and professional conduct.
- If codes of ethics is not applied, disciplinary actions may be taken.
- Maintenance of professional codes of ethics helps the accountancy profession to act in the public interest by providing appropriate regulation of members.

The fundamental principles

1. Integrity - members should be straightforward and honest in all professional/business relationships. Do not provide false, misleading or incomplete information.
2. Objectivity - members do not allow bias or conflict of interest in business judgement. Avoid conflict of interest and influences.
3. Competence - duty to maintain professional knowledge and skill at appropriate level.
4. Confidentiality - information on clients not disclosed without appropriate specific authority.
5. Professional behaviour - members should comply with relevant laws and avoid actions discrediting the profession.

Question: Pilot paper

Explain why it is necessary for external auditors to be and be seen to be independent.(3)

Key points: Independence in terms of attitude, appearance and mind

- Agency theory: because they act on behalf of the owners (shareholders) and report on the FS prepared by appointed management staff for the benefit of the shareholders.
- Statute: national legislation requires it.
- The ACCA rules of Professional Conduct: require that auditors are independent and they are seen to be independent. The rules cover a number of areas in which auditors independence may be, or be seen to be impaired.
- Impair objectivity: if they are independent, their objectivity and ability to form an opinion on the FS is impaired e.g. own shares in the entity they audit.
- Instill confidence: auditors must be seen to be independent because if they are not independent, the owners of the business will not have confidence in the audit report that they issue.
Threats to independence

1. **Self-interest threat** - financial or other interests of members or their close family.
2. **Self-review threat** - when the auditor has to re-evaluate work completed by himself.
3. **Advocacy threat** - when the auditor is asked to promote the client’s position or represent them in some way.
4. **Familiarity threat** - when the auditor is too sympathetic or trusting of the client because of a close relationship with them.
5. **Intimidation threat** - intimidates the auditor to give an unqualified opinion otherwise not re-appoint him.

Areas of risks

- Financial interests
- Family relationships
- Business relationships
- Loans
- Fees
- Undue independence
- Gifts and hospitality
- Second opinion
- Provision of other services

Auditors specific threats to their independence and objectivity

1. **Dependence on income** - from a particular client or group of clients may impair objectivity and independence.

Implications - auditor may not qualify the audit report when qualification is required because this will upset client who may move to another audit firm and thus cause loss of significant income.

Safeguards

- Do not accept certain assignments.
- Resign from certain assignments.
- Do not stand for reappointment as auditor.
- Reduce non audit work with a view to control gross practice income from that particular client.
- As a general rule, recurring fees paid by one or group of connected clients should not exceed the threshold of the gross practice income as follows:
  - Listed: 10%
  - Non Listed: 15%
2. **Family or other personal relationships**- problems may arise where a practice or anyone closely connected with it has a mutual business interest with a client or with the employee of a client.

**Implications**- auditor loses independence as he has a conflict between maintaining professional standards and personal relationships. Family relationships may create self interest, familiarity or intimidation threats.

**Safeguards**

- Remove, rotate, and reassign staff or partner from audit assignment.
- Establish policies and procedures within audit firm so that audit staff disclose issues that affect their independence in an assignment.
- If unaware of relationship of staff, review all work performed by him.

3. **Beneficial interests in shares and other investments**: a practice should ensure that it does not have as an audit client a company in which any partner or anyone closely connected with a partner hold shares or has a beneficial interest in shares and financial instruments. Shares or other financial instruments inherited or acquired by marriage should be disposed at the earliest and not at a date where it may tantamount to insider dealing.

**Implication**: may be tempted to look at self interest. Auditor may disregard adverse events at the client or not qualify the audit report when qualification is required because it will affect the share price. Focus on dividend. May hide liabilities or overstate assets to improve dividend or not to decrease dividend.

**Safeguards**:

- Dispose the entire financial interest.
- Not involved in audit.
- Disclosure of interest.
- If aware of interest of staff, review all work performed by him.

4. **Loans and guarantees**- members should not make a loan to a client or accept a loan from a client unless it is an arm’s length transaction in the normal course of business. Similar restrictions apply to making or accepting guarantees in respect of a loan.

**Implication**: auditor may not qualify the audit report when qualification is required because it will affect the going concern of the client and will be unable to pay the loan. This may lead to self interest threat and intimidation threat and affect perceived independence.

**Exceptions**:

- The client is a bank or similar institution.
• The loan is made in the ordinary course of business on normal business terms.
• The loan is not material.

**Safeguard:**

• Not to accept/make a loan/guarantees from audit clients.

5. **Goods and services hospitality** - goods and services should not be accepted by a practice or by anyone closely connected with it (e.g. spouse) **unless the value of any benefit is modest.**

*Implication:* undue/excessive hospitality e.g dinner in expensive restaurants, free holiday, expensive gifts affect the objectivity principle. **Independence is impaired,** familiarity is created and it creates self interest threats.

**Exceptions:**

• Value is immaterial
• Made in the normal course of business without intention to influence auditor or to obtain favour.

**Safeguards:**

• Not to accept expensive hospitality and gifts.

6. **Close business relationships:** when audit partner is director of the client company or audit firm enters into joint venture with audit client. Close family member of auditor has interest in client firm.

*Implications:* Auditor may not qualify the audit report when qualification is required because it will affect business relationships.

**Safeguard:** Not to have close business relationship with audit client/ staff

7. **Provisions of other services to audit clients:**

**Non audit services:** IT consultancy, risk assessment management consultancy, tax advice, preparing FS. Provisions of non audit services is acceptable but care must be taken NOT to perform management functions or to make management decisions.

*Implications:* threat is that fees from other services > fees from audit. Where a qualified audit opinion is warranted, the client may threaten the auditor to allocate the other services to another firm so that the audit is not qualified. A **self review** threat occurs when the auditor is doing statutory audits and he will then be reviewing its own work.. E.g. if the external auditor prepared the financial statements and then audited them.

**Safeguards:** Creation of Chinese walls (segregation of duties) meaning that different teams are performing the non audit services not involved in management functions.
8. Audit fees

Overdue fees - the existence of overdue fees can be a threat to objectivity as this can amount to loan to client.

**Safeguard:** delay start of audit until all outstanding fees have been settled.

**Question-Dec 03**

Client confidentiality underpins the relationship between Chartered Certified Accountants in practice and their clients. It is a core element of ACCA’s *Rules of Professional Conduct*.

**Required:**

(a) **Explain the circumstances in which ACCA’s Rules of Professional Conduct permit or require external auditors to disclose information relating to their clients to third parties without the knowledge or consent of the client.** (8 marks)

Information confidential to a client should NOT be disclosed except where consent of client has been obtained or where it is a public duty, or a legal or professional right, or duty to disclose.

**Obligatory disclosures (without client permission)**

- Certain specialist units within police forces under legislation e.g. financial services legislation, legislation concerning banks and insurance companies, money laundering, serious fraud and tax evasion.
- Where the courts order them to do so (legal right or duty)
- Where they suspect their clients of terrorism offences.
- Where they suspect their client to be a drug trafficker or laundering drugs trafficking proceeds.
- Under specific legislation(e.g. Banking Act), they can disclose to regulatory body, (Central Bank) where they consider that client is acting recklessly or is not fit and proper person to manage the business.

**Voluntary disclosure (without client permission)**

- Where the audit firm is involved in litigation e.g fees recovery.
- Where they are subject to disciplinary proceedings(e.g. negligence)
- If it is in public interest or the interest of national security.

(b) A waste disposal company has breached tax regulations, environmental regulations and health and safety regulations. The auditor has been approached by the tax authorities, the government body supervising the award of licences to such companies and a trade union representative. All of them have asked the auditor to provide them with information about the company. The auditor has also been approached by the police. They are investigating a suspected fraud perpetrated by the managing director of the company and they wish to ask the auditor certain questions about him.

**Required:**

Describe how the auditor should respond to these types of request. (12 marks)
✓ **General:** It is common for various bodies to informally ask for information from an auditor.

✓ **As a basic rule:** Auditor must not disclose information without consent of client unless he is forced to do so by a court of law.

✓ The authorities have powers to ask clients to disclose information voluntarily. They also have statutory powers to ask for information both from clients and auditors. Same rule apply to environment and health and safety inspectors who delivers licences.

✓ Trade union has no statutory power to ask for information.

✓ Police demand for information on suspected fraud: check if it as per statue- See Scenarios 1 to 3.

✓ **Scenario 1: client not aware but can be made aware of request:** if the auditor has no statutory duty not but to inform the client that an approach has been made (in relation to police case), the auditor can approach the client to obtain consent and see if the client is aware of the investigations. The auditor should ensure that the client is aware that voluntary disclosures may be in client favour in the long run.

If the client refuses, the auditor must inform the client that he (as auditor) will have to disclose the required information if it is requested under statue.

✓ **Scenario 2: client already aware:** where client and auditor are aware of the investigation and if auditor has information of potential actions against the client may affect FS, he must measure the impact on the audit report. Consider any provisions or disclosures.

✓ **Scenario 3: client not aware and cannot be made aware of the request:** where the client not aware of investigation and auditor has a statutory duty NOT to inform client and the auditor thinks that the investigation *materially* affects the FS which will require provisions and disclosures, auditor to consider resignation.

- Even with resignation, situation will not improve as the auditor will have to make a statement on resignation. Auditor to seek legal advice what to do.
- Check that the suspected fraud relating to the MD affects the FS.
- Seek assistance: to take advice in all cases where need is felt.
Dec 2008- Stark Co
You are a manager in the audit firm of Ali & Co; and this is your first time you have worked on one of the firm’s established clients, Stark Co. The main activity of Stark Co is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Stark is regulated by the relevant financial services authority.

You have been asked to start the audit planning for Stark Co, by Mr Son, a partner in Ali & Co. Mr Son has been the engagement partner for Stark Co, for the previous nine years and so has excellent knowledge of the client. Mr Son has informed you that he would like his daughter Zoe to be part of the audit team this year; Zoe is currently studying for her first set of fundamentals papers for her ACCA qualification. Mr Son also informs you that Mr Far, the audit senior, received investment advice from Stark Co during the year and intends to do the same next year.

In an initial meeting with the finance director of Stark Co, you learn that the audit team will not be entertained on Stark Co’s yacht this year as this could appear to be an attempt to influence the opinion of the audit. Instead, he has arranged a balloon flight costing less than one-tenth of the expense of using the yacht and hopes this will be acceptable. The director also states that the fee for taxation services this year should be based on a percentage of tax saved and trusts that your firm will accept a fixed fee for representing Stark Co in a dispute regarding the amount of sales tax payable to the taxation authorities.

Required:
(a) (i) Explain the ethical threats which may affect the auditor of Stark Co. (6 marks)
(ii) For each ethical threat, discuss how the effect of the threat can be mitigated. (6 marks)
(b) Discuss the benefits of Stark Co establishing an internal audit department. (8 marks)
(20 marks)

Answers: (a)&(b)

Threats

- Mr Son has been the engagement partner for Stark Co, for the previous 9 years.
- Familiarity threat- may affect the independence of Mr Son.

Safeguard

- Rotation of audit engagement partner.

Threats

- Mr Son’s daughter Zoe will form part of the audit team this year.
- As Mr Son has a good relationship with Stark Co, Zoe may be tempted not to identify errors in case this prejudiced her father’s relationship with the client.

Safeguards

- Zoe not to form part of the audit team.
Threats

- Mr Far, the audit senior, received investment advice from Stark Co during the year and intends to do the same next year.
- Independence may be affected if a reduced fee is charge.

Safeguards

- Mr Far should not use the services of Stark Co again unless this is first agreed with the engagement partner.

Threats

- The audit team was entertained on Stark Co’s yacht last year.
- Stark arranged a balloon flight this year.

Safeguards

- Hospitality should not be accepted unless modest value.
- May impede on independence.
- Not to accept, also investigate whether partner aware.

Threats

- Fee for taxation services based on a % of tax saved
- Pressure to gain the highest tax refund for higher fee
- Tempt the audit firm to suggest illegal tax avoidance schemes.

Safeguards

- Contingent fee should not be accepted
- Fee charged on time and experience

Threats

- Represent Stark Co in a dispute regarding the amount of sales tax payable to the taxation authorities- advocacy threat.

Safeguards

- Objectivity could be comprised
- Should not represent client in court

(c) Benefits of Stark Co establishing an IA department

- Report to management and audit committee on problematic areas
- Ensure good governance.
- Assess and advice on risks and controls.
- Ensure Stark complies with law and regulations.
You are an audit manager in McKay & Co, a firm of Chartered Certified Accountants. You are preparing the engagement letter for the audit of Ancients, a public limited liability company, for the year ending 30 June 2006.

Ancients has grown rapidly over the past few years, and is now one of your firm’s most important clients. Ancients has been an audit client for eight years (familiarity threat) and McKay & Co has provided audit, taxation and management consultancy advice during this time.—provn of others services.

The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 2005 remains unpaid.—Overdue fees

Audit personnel available for this year’s audit are most of the staff from last year, including Mr Grace, an audit partner and Mr Jones, an audit senior. Mr Grace has been the audit partner since Ancients became an audit client.—Familiarity threat

You are aware that Allyson Grace, the daughter of Mr Grace, has recently been appointed the financial director at Ancients.

To celebrate her new appointment, Allyson has suggested taking all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year. Hospitalitity—value should be modest

Required:
Identify and explain the risks to independence arising in carrying out your audit of Ancients for the year ending 30 June 2006, and suggest ways of mitigating each of the risks you identify. (12 marks)

- Fee income—Ancients=public limited liability. Obtaining more than 10% of its recurring practice income could indicate undue financial reliance on one client and impair objectivity. No details provided about fees. If 10% limit is close consider providing limited services so that independence is not impaired.
- Unpaid taxation fees- non payment of taxation fees is a threat to objectivity and it tantamount to an unpaid loan. If the need arise to issue a modified report, the auditor will hesitate because of the fear that the client leaves him and the fees remains unpaid.
  Solution: Consider delaying start of audit till fees are paid. If fee is not settled, decline assignment to carry the audit.
- Audit partner—time in office for 8 years—objectivity for the audit may be threatened by the ongoing close relationship with the client i.e too friendly with directors of Ancients. May put the audit partner in a position where he won’t be able to take independent decision like qualifyng report (if need arise) because of his friendship.
  Solution: To rotate audit partner.
- Relationship: Allyson Grace is not deemed to be connected to Mr Grace because she is presumably over 18 years of age. If still a minor, then it is inappropriate for Mr Grace to be audit partner as he would influence Allyson decision. But still independence is not total( appear to general public that independence is impaired.) as
he may hesitate to annoy his daughter by qualifying the audit report. Solution-
Recommended to appoint another audit partner so that the audit is seen to be
independent.

- Meal: Expensive meal affects independence as staff of audit team may be too friendly
  with Allyson. Modest gifts are allowed but not expensive one. Solution-To decline
  invitation.

June 07- Green Co

Green Co grows crops on a large farm according to strict organic principles that prohibits the
use of artificial pesticides and fertilizers. The farm has an ‘organic certification’, which
 guarantees its products are to be organic. The certification has increased its sales of flour,
 potatoes and other products, as customers seek to eat more healthily.

Green Co is run by two managers who are the only shareholders. Annual revenue is $50
million with a net profit of 5%. Both managers have run other businesses in the last 10 years.
One business was closed due to suspected tax fraud (although no case was ever brought to
court).

Green Co’s current auditors provide audit services. Additional assurance on business controls
and the preparation of financial statements are provided by a different accountancy firm.

Last year, a neighbouring farm, Black Co started growing genetically modified (GM) crops,
the pollen from which blows over Green Co’s fields on a regular basis. This is a threat to
Green Co’s organic status because organic crops must not be contaminated with GM
material. Green Co is considering court action against Black Co for loss of income
and to stop Black Co growing GM crops.

You are an audit partner in Lime & Co, a 15 partner firm of auditors and business advisors.
You have been friends with the managers of Green Co for the last 15 years, advising them on
an informal basis. The managers of Green Co have indicated that the audit will be put out to
tender next month and have asked your audit firm to tender for the audit and the provision of
other professional services.

Required:
(a) Using the information provided, identify and explain the ethical threats that could
affect Lime & Co.

(8 marks)

Solutions:

Association threat

The managers of Green Co, while not being criminals, they appear to lack integrity in their
business affairs. The partners in Lime & Co need to decide whether they want to be
professionally associated with green Co: any criminal activity in the future may be an adverse
effect on Lime & Co’s reputation and image. Specifically Lime & co will not want to be seen
to be associated with or advising a firm which is breaking the law.

Advocacy threat

This threat arises because Lime & Co may be asked to present details of Green Co’s financial
statements and profit forecasts in court to support its application to stop Black Co growing
genetically modified (GM) crops. Lime&Co may be seen to support their client in court, which may limit their independence in relation to the audit work.

**Cease trading- payment of fees.**

The farm may lose organic certification if it genetically modified crops continue to be grown next to Green Co’s farm. There is a risk that Lime & Co may not be paid for services provided should Green Co cease trading.

**Familiarity threat**

You have been friends with the managers of Green Co for some time. This means that you may not question the decisions of the managers due to this close personal relationship. As a partner in Lime & Co you will in effect not be independent from your client.

**Management threat**

There is a risk that Lime & Co will make decisions that the managers of Green Co should make (for example which accounting policies should apply to the FS). It is possible that these type of decisions have been made before, on an informal basis, as the partners in Lime & Co already know and give advice to the managers of Green Co.

**Self-review threat**

If Lime & Co provides audit and other professional services to Green Co, then they will be preparing the FS and also auditing those FS. This will provide a self review threat to Lime & Co as they will be auditing their own work. Lime & Co would be advised to tender only for the audit work.

**Fee income**

Acceptance of audit and professional services work from Green co, will result in an increase in fee income. To retain independence, Green Co need to ensure that fee income does not exceed 15% of the total practice income.