

Course: Financial Audit

Lecture 5: Ethics for Professional Accountant

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Introduction

Overview of Lecture 4

Ethics

- Ethics refer to a well-defined system of moral principles that guide individuals in differentiating right from wrong.
- Ethics are not just personal but are also shared across cultures and societies, often forming the foundation of communal values and norms.
- Ethics touch on concepts such as justice, fairness, and equity, and they evolve over time as societal norms change.

Ethics Behavior

- Ethical behavior is fundamental for maintaining social harmony and ensuring that systems operate smoothly. Society relies on individuals to act according to moral principles to avoid chaos and anarchy.
- Many ethical principles are so critical that they become ingrained in the legal systems of nations. However, laws can only go so far. Certain ethical values, like striving for excellence and maintaining integrity in all circumstances, cannot always be captured by legal rules.
- In professions such as accounting, ethical behavior becomes the bedrock for establishing public trust. By voluntarily adhering to a code of ethics, professionals demonstrate self-discipline that goes beyond the minimum legal standards.

Professional Accountants

- The attitudes and conduct of professional accountants play a significant role in shaping the financial and economic stability of their countries. Accounting professionals have the power to influence major business decisions through their services, which makes their ethical responsibility immense.
- Accountants must consistently provide high-quality, unbiased services to maintain this trust. Ethical lapses could result not only in personal or corporate failure but also in a loss of confidence that can impact the broader economic environment.

Accounting Professions

- The accounting profession's defining characteristic is its commitment to the public interest. Accountants serve both their clients and the general public by ensuring the accuracy and reliability of financial information.
- The standards of this profession, therefore, go beyond the expectations of individual clients and are largely determined by what benefits society as a whole
- Without this, the public and stakeholders, including investors and regulators, would lose confidence in financial markets. In essence, accountants are the stewards of public trust, and their work revolves around the principle of credibility.
- Their responsibility is not only to their immediate clients but also to the broader community that depends on the transparency and integrity of financial systems.

Code of Ethics

- IFAC's Code of Ethics is a global benchmark for professional accountants, providing them with guidance that transcends national boundaries. The International Federation of Accountants (IFAC) plays a key role in establishing these standards through its Ethics Committee, which is responsible for researching and reviewing ethical issues that arise in the profession.
- The code helps ensure that accountants worldwide adhere to a common set of ethical principles, thus promoting consistency and trust in international financial practices.
- The Code of Ethics is not just a static set of rules but is periodically updated to reflect emerging ethical challenges.

Code of Ethics

- The Code of Ethics is divided into three main parts, each addressing different categories of accountants:
 - **Part A** applies to all professional accountants, setting forth the fundamental principles that all must follow regardless of their specific role or sector.
 - **Part B** is tailored specifically for accountants in public practice, where they often serve external clients.
 - **Part C** pertains to employed professional accountants who work within organizations.

Code of Ethics

- The process of establishing ethical principles varies globally due to cultural, legal, and institutional differences. In countries like France and Japan, the ethical codes for accountants are part of the legal system, ensuring strict compliance through legislative mechanisms
- IFAC's Code of Ethics offers a flexible framework that can be adapted to national contexts while providing a uniform global standard

Code of Ethics

- The six fundamental principles of ethics provide a clear moral compass for accountants, regardless of their specific role or country of practice:
 - Integrity involves acting with honesty and strong moral principles.
 - Objectivity ensures that accountants remain impartial and do not let personal biases or external pressures affect their professional judgments.
 - Professional competence and due care require accountants to continually update their knowledge and skills, ensuring they can provide competent services.
 - Confidentiality means safeguarding sensitive client or employer information, protecting it from unauthorized disclosure.
 - Professional behavior requires accountants to act in accordance with laws and regulations, maintaining the profession's reputation.
 - Technical standards ensure that accountants adhere to the latest guidelines, practices, and methodologies required to perform their duties effectively.

Code of Ethics

- The Proposed Revised Code of Ethics includes a requirement for accountants to assess potential threats to complying with the fundamental principles whenever they become aware of circumstances that could compromise their ethical integrity.
- This proactive approach encourages accountants to remain vigilant about possible conflicts and take steps to mitigate risks before they become problematic.

Code of Ethics

- A professional accountant must always act with transparency and honesty when delivering services. This includes any service that requires the expertise of accounting, auditing, taxation, financial management, or consultancy.
- Maintaining straightforwardness in professional interactions is key to building trust with clients, stakeholders, and the public.

Code of Ethics

- The principle of objectivity obliges accountants to be intellectually honest and avoid situations that might bias their professional judgment.
- The nature of accounting work often exposes professionals to pressures from clients, employers, or other parties who may attempt to influence the outcome of an audit or financial report.

Code of Ethics

- Accountants may face situations where their ethical responsibilities conflict with internal or external pressures.
- Accountants need to be equipped to manage these conflicts, maintaining their ethical obligations while balancing the expectations of their employer or clients.

Code of Ethics

- The IFAC Code of Ethics provides a clear process for resolving ethical conflicts:
 - The first step is to escalate the issue within the organization, seeking resolution at higher management levels if necessary.
 - If the conflict remains unresolved, accountants should seek external advice from professional bodies or independent advisors.
 - As a final measure, if no resolution can be found, the accountant may have to resign from the organization, ensuring that all necessary parties are informed of the ethical conflict.

Code of Ethics

- The decision to provide professional services signals that an accountant is confident in their abilities to fulfill the task.
- To maintain their professional edge, accountants must engage in ongoing education and adopt quality control programs within their firms to ensure high standards are met

Code of Ethics

- Accountants should avoid accepting tasks beyond their expertise unless they seek appropriate guidance or assistance. Even in areas where they are competent, the expectation is that services will be performed with the highest levels of care and accuracy.
- This diligence includes staying current with legislative changes, industry standards, and best practices, ensuring that their work reflects the latest developments in the field.

Code of Ethics

- One of the most important ethical obligations of a professional accountant is confidentiality. The information they access during engagements is often sensitive and proprietary, and accountants must protect this information from unauthorized disclosure.
- The duty to maintain confidentiality does not end when the accountant's relationship with a client or employer ends; it is a lifelong responsibility.

Code of Ethics

- Confidential information may only be disclosed in certain circumstances, such as when authorized by the client, required by law, or necessary for fulfilling a professional duty.
- Before making such disclosures, accountants should weigh the potential impact on all parties involved, including third parties who might be affected by the release of sensitive information.

Code of Ethics

- In some cases, legal obligations may require accountants to disclose confidential information.
- The specific legal requirements surrounding confidentiality vary across jurisdictions, so accountants need to be familiar with the laws governing their particular country or region.

Code of Ethics

- Accountants are expected to act in a way that upholds the reputation of their profession, avoiding any actions that might bring it into disrepute.
- Their responsibilities extend beyond their immediate clients to include the public, fellow professionals, and their employers. This responsibility includes maintaining a high standard of conduct in all professional dealings.

Code of Ethics

- When providing tax services, accountants are allowed to represent the interests of their clients or employers, but only within the bounds of legality and ethical conduct.
- If an accountant believes that a tax return contains material errors or misstatements, they should not sign it, as doing so could expose them to legal or ethical consequences.
- Additionally, if estimates are used in the preparation of tax documents, these should be clearly identified as such, along with an explanation of the uncertainty involved.

Ethical Compliance

- When providing services abroad, differences in ethical guidelines between the host country and international frameworks such as the International Federation of Accountants (IFAC) Code of Ethics can present challenges. To navigate this complexity, accountants must apply the following principles,
- When the ethical standards of the host country are less stringent than those mandated by the IFAC Code, it is essential to adhere to the higher international standards.

Ethical Compliance

- In cases where the ethical requirements of the host country exceed those of the IFAC, accountants are obligated to comply with the stricter local rules, reflecting the primacy of national law in safeguarding local interests.
- Moreover, if the accountant's home country imposes mandatory ethical requirements that are more rigorous than both the IFAC and host country regulations, those home-country rules must prevail.

Public Representation

- The manner in which accountants present themselves to the public is crucial for maintaining the profession's integrity. Publicity surrounding an accountant's qualifications and services should always be factual and restrained. Therefore, accountants must,
- Avoid any form of advertising that could harm the profession's reputation, as this could lead to a loss of credibility both individually and collectively.
- Ensure that any claims made regarding their services, qualifications, or experience are accurate and not overstated.
- Accountants should also refrain from making negative remarks about the work of other professionals.

Professional Standards

- Professional services provided by accountants must always comply with established technical and professional standards.
- These include globally recognized frameworks such as the International Standards on Auditing (ISA) and the International Financial Reporting Standards (IFRS).

Ethical Guidelines

- Although ethical guidance applies universally to all accountants, Part B of the IFAC Code of Ethics specifically addresses those in public practice. This group includes partners, employees, and anyone involved in delivering professional services such as audits, tax advisory, or consulting. Ethical responsibilities in public practice extend to areas such as:
 - **Independence:** Ensuring impartiality and objectivity when dealing with clients.
 - **Client Relationships:** Transparent handling of fees, commissions, and client funds.
 - **Professional Relations:** Ethical behavior toward peers, including proper advertising and avoiding conflicts of interest.

Auditor Independence

- Auditor independence is the cornerstone of audit credibility.
- The absence of independence could lead to systemic issues, where inaccurate financial information distorts market efficiency and leads to misinformed decisions by investors and other stakeholders.

Auditor Independence

- Auditor independence standards vary across jurisdictions, reflecting different legal frameworks and cultural expectations. While many countries adopt international standards, such as those recommended by the IFAC, national rules may diverge in key areas, such as:
 - The scope of individuals required to maintain independence.
 - Permissible financial or business relationships with clients.
 - The provision of non-audit services alongside audit functions.
 - Appropriate safeguards to mitigate threats to independence.

Auditor Independence

- Under the European Union's Eighth Company Law Directive, member states have discretion in defining the conditions of independence for statutory auditors.
- Article 24 stipulates that statutory audits should not be conducted unless the auditor is independent, according to the member state's legal requirements.

Auditor Independence

- The EU framework, similar to IFAC's threat and safeguard approach, underscores that auditors must be independent both in mind and appearance.
- Independence of mind allows auditors to exercise professional skepticism and objectivity, while independence in appearance ensures that their actions do not appear biased to a reasonable and informed observer.
- The combination of these two forms of independence protects the public's trust in the audit process and ensures that the audit's conclusions are perceived as credible.

Auditor Independence

- In the U.S., the Sarbanes-Oxley Act mandates strict guidelines on auditor independence for firms auditing publicly traded companies.
- The Public Company Accounting Oversight Board (PCAOB) enforces these regulations, ensuring that auditors maintain independence in all relevant engagements.

Auditor Independence

- Independence, from an auditing perspective, is defined as the ability to remain impartial and objective throughout the audit process. It consists of two key elements:
 - Independence of Mind: The auditor's ability to exercise professional judgment without external influences, ensuring the integrity of the audit process.
 - Independence in Appearance: The perception of independence by external parties, ensuring that no conflicts of interest or biases are perceived.
- A robust principles-based framework, as outlined in Section 8 of the IFAC Code of Ethics, guides auditors in identifying, evaluating, and addressing threats to independence.

Threats

- The IFAC Code of Ethics identifies several types of threats to independence, including,
- Self-interest threats - arising when an auditor has a financial interest in the client, such as owning shares or receiving significant fees.
- Self-review threats - occurring when auditors must review their own previous work, particularly if they were involved in preparing the financial statements being audited. In such cases, auditors should recuse themselves or establish a second layer of review to mitigate bias.

Threats

- Advocacy Threat occurs when an auditor's impartiality is compromised because they are perceived to be, or are actively, supporting an assurance client's position or opinion. Common situations that could create such a threat include,
- Financial involvement, such as selling or underwriting securities for the client, which introduces conflicts of interest between the auditor's independent role and their potential personal or financial gain.
- Legal advocacy, where the auditor represents or advocates for the client in legal matters, making it difficult to maintain the neutrality expected of auditors.

Threats

- Familiarity Threat arises when the auditor develops close relationships with the client's personnel, leading to a diminished level of professional skepticism. Examples include:
 - Close family connections, such as having immediate family members who are directors or executives within the client organization, can compromise the auditor's ability to remain unbiased.
 - Long-term association, where an auditor has been working with a client for many years, may also cause the auditor to unintentionally become lenient in their assessment of the client's financial reporting processes.

Threats

- Intimidation Threat occurs when auditors are placed under pressure by the client's management or board, potentially leading them to compromise their judgment. This threat manifests when auditors feel their job security or engagement terms are at risk due to disagreements with the client, particularly regarding:
 - Disputes over accounting principles, where the client pressures the auditor to accept an accounting treatment that is inconsistent with professional standards.
 - Pressure to reduce audit scope, often as a cost-saving measure, which may prevent the auditor from obtaining sufficient evidence to form a reliable opinion.

Threats

- Safeguards Against Threats are essential in preserving the integrity of the audit process. These safeguards fall into three main categories:
 - Safeguards created by profession, legislation, or regulation: These include the establishment of professional standards for auditors, ongoing educational requirements, and ethical codes that regulate auditor conduct.
 - Client-based safeguards: These include governance structures within the client organization, such as an audit committee that oversees financial reporting and ensures that the audit engagement is conducted impartially.
 - Firm-based safeguards: Within the audit firm, policies and procedures should be in place to ensure compliance with ethical requirements.

Threats

- Additional Engagement-specific Safeguards include using external experts to review work done by the audit team, involving independent third parties to provide oversight, or rotating senior auditors to mitigate long-term familiarity threats.

Prohibited Services

- The IFAC Code explicitly prohibits auditors from providing certain services to their audit clients, to prevent conflicts of interest. These services include,
 - Bookkeeping or payroll processing that would otherwise fall within the scope of the financial statements being audited.
 - Valuation services where significant judgment is required, and which could materially affect the audit opinion.
 - Management decision-making roles, such as determining or executing corporate decisions, which would compromise the auditor's objectivity.
 - Litigation support, as serving in an advocacy role conflicts with the auditor's duty to maintain skepticism.

Technology-related Services

- While auditors are permitted to provide certain technology-related services, such as financial information systems design and implementation, specific safeguards must be in place.
- These safeguards ensure that the audit client maintains full responsibility for system control, decisions regarding system operation, and management of data.

Outsourcing

- Internal Audit Outsourcing is allowed under the IFAC Code, but only with appropriate safeguards to avoid self-review threats.
- This means ensuring that the auditor's role in internal audit is clearly separated from the overall management control of internal audit functions, thus maintaining independence in both audit and assurance services.

Fees & Pricing

- The Ethics Code emphasizes that professional fees should reflect the true value of the services rendered, considering the complexity, responsibility, and expertise required for the engagement.
- Auditors should avoid pricing practices that could impair independence, such as undercutting fees to retain business or accepting contingency fees based on the outcome of the audit.

Relations

- When audit clients require services outside the auditor's expertise or geographical reach, the auditor should seek assistance from other professionals without compromising client interests. Referring clients to specialists or collaborating with other firms should always prioritize the quality of the audit and adherence to ethical principles over competitive concerns.
- In summary, independence is the cornerstone of the auditing profession, and the application of comprehensive safeguards is necessary to maintain auditor objectivity. Ethical guidelines, regulatory oversight, and internal procedures must work in harmony to ensure that auditors can perform their duties without bias or conflict of interest.

Accountant Supersession

- When a new accountant is set to replace an existing one, adherence to the Code of Ethics is essential to preserve professional integrity. The incoming accountant must evaluate whether any ethical or professional reasons could prevent them from accepting the new role.
- Moreover, the communication between accountants serves a dual purpose. It prevents the incoming accountant from engaging with a client who may have ulterior motives, such as undermining or bypassing the independent judgment of the former accountant.

Accountant Supersession

- The extent of the information exchange between the existing and incoming accountants is largely dictated by the client's permission and relevant legal or ethical standards. While the requirement to seek the client's explicit consent for this communication is a safeguard, it raises the question of whether this protocol is efficient.
- Once granted access to any pertinent information, the proposed accountant must treat it with the highest level of confidentiality and professionalism. It is equally important for the proposed accountant to confirm whether the client has informed the previous accountant of the change and whether full permission for open communication has been granted.

Accountant Supersession

- After obtaining consent, the new accountant should explicitly request any relevant information from the outgoing accountant that could impact the decision to accept the appointment.
- In cases where the previous accountant fails to respond within a reasonable time, it is advisable for the incoming accountant to make additional efforts to contact them. This approach ensures that due diligence is carried out, and the professional integrity of the process is maintained.

Accountant Supersession

- Furthermore, after a change in accountants, it is expected that the outgoing accountant promptly transfers all necessary documents and records to the incoming accountant to ensure continuity of service for the client.
- In situations where competitive bids are required for assurance services, accountants should specify in their proposals that they will need to consult with the previous accountant before accepting the engagement.

Ethical Boundaries

- Advertising and solicitation are areas of accounting that vary greatly in practice, depending on local regulations. While some countries permit accountants to advertise their services, others strictly prohibit it.
- Ethical advertising should inform potential clients of the services and expertise provided by the accountant in a manner that is respectful and devoid of misleading or exaggerated claims.

Ethical Boundaries

- Prohibited practices in advertising include making unrealistic promises of favorable outcomes, suggesting the ability to improperly influence legal or regulatory bodies, and boasting about services in a way that cannot be substantiated by facts.
- In cases where advertising is restricted, accountants can still engage in publicity efforts that are consistent with ethical standards. Publicity, unlike advertising, must be neutral and focused on sharing factual information.

Ethical Guidelines

- Part C of the Ethics Code focuses on accountants who work in sectors outside of public practice, such as industry, education, or the public sector. These accountants face unique ethical challenges, particularly when balancing their loyalty to their employer with their professional responsibilities.

Conflict of Loyalties

- Accountants employed in non-audit roles owe their primary loyalty to their employer, yet they must still uphold their professional obligations. While supporting the organization is a priority, an accountant cannot be asked to act unlawfully, distort financial records, or mislead auditors.
- If no resolution is possible, resignation may be the only viable option, though it should be handled discreetly. The accountant is bound by confidentiality and cannot disclose the reasons for their resignation unless required by law.

Professional Competence

- Accountants in non-public practice roles are often tasked with responsibilities that fall outside their immediate expertise. In such situations, it is imperative that they do not mislead their employers about their qualifications or experience.
- Accountants are also expected to present information in a transparent, honest, and timely manner. Financial and non-financial data should be recorded accurately, reflecting the true nature of business transactions.

Enforcement of Ethical Standards

- The enforcement of ethical standards varies significantly across different jurisdictions. In countries like the United States, penalties for ethical breaches may range from a simple reprimand to expulsion from professional organizations.
- In other countries, such as Japan, France, and Germany, government agencies play a more active role in enforcing ethical standards. Violations of these standards can result in criminal penalties, including fines or imprisonment, depending on the severity of the breach.

Enforcement of Ethical Standards

- While IFAC provides guidance on ethical standards, it does not have the authority to enforce penalties directly. Instead, it relies on national legislation and the internal policies of professional bodies to uphold the ethical code.
- Sanctions can range from fines to suspension or expulsion from membership in professional bodies. Other penalties may include requiring additional education, refunding client fees, or transferring the client's work to another professional at the disciplined accountant's expense.

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Conclusion

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Closing

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014