

# **Principles of Auditing: An Introduction to International Standards on Auditing**

## **Chapter 3 – Ethics for professional accountants**

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# What are ethics?

- A sense of agreement in a society as to what is right and wrong.
- Ethics represent a set of moral principles, rules of conduct or values.
  - Ethics apply when an individual has to make a decision from various alternatives regarding moral principles.

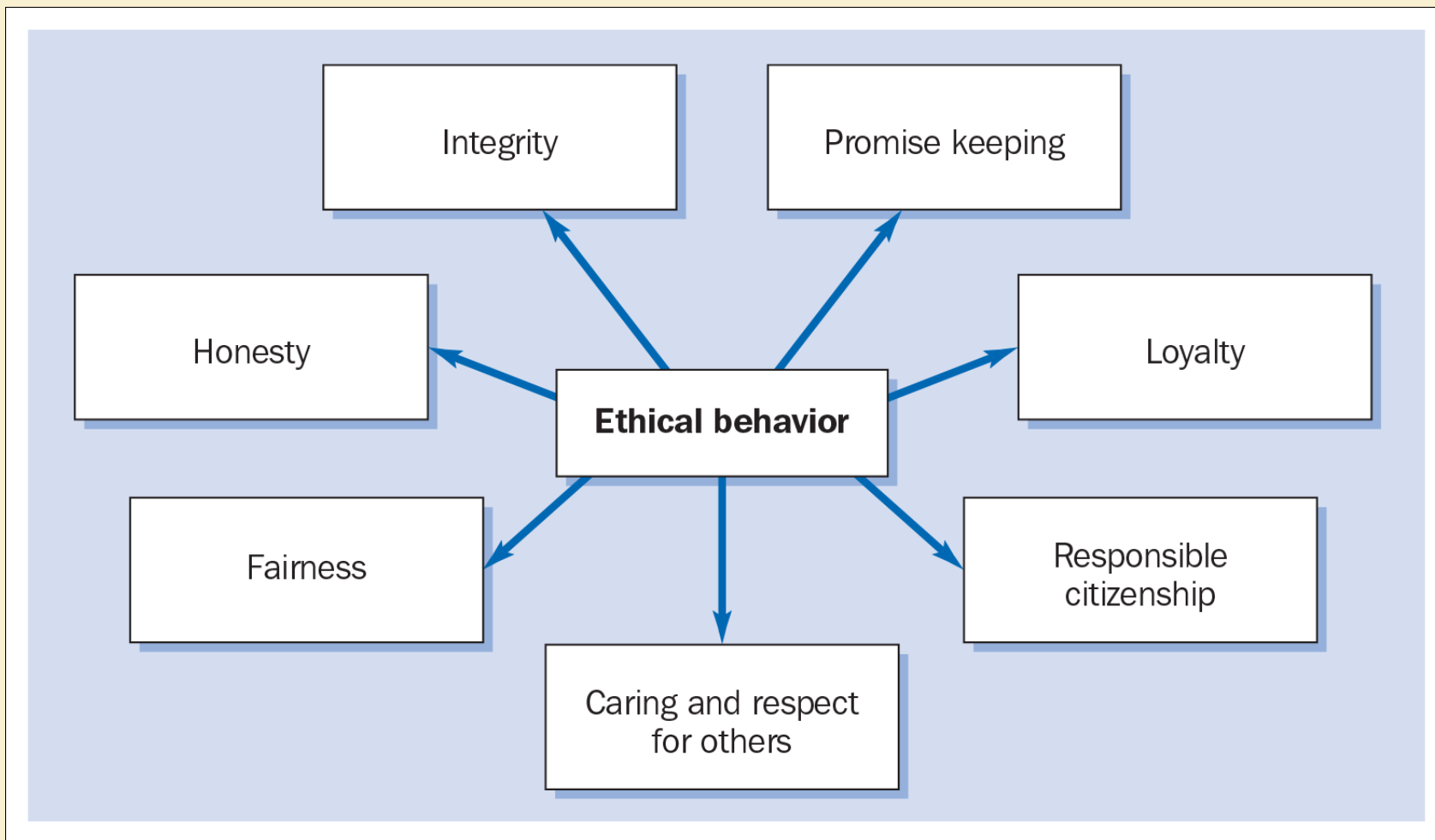


Illustration 3.1 Ethical Principles

# Objectives of accountancy profession

- Generally, to meet the public's interest  
‘A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer.’ Code of Ethics

# PCAOB ethics – US classes

- ET Section 100 INDEPENDENCE, INTEGRITY AND OBJECTIVITY
- Independence ET Section 101  
<http://pcaobus.org/Standards/EI/Pages/ET101.aspx>
- Integrity and Objectivity ET Section 102  
<http://pcaobus.org/Standards/EI/Pages/ET102.aspx>

US classes

## The code is divided into three parts: A, B and C:

- Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles.
- Parts B and C illustrate how the conceptual framework is to be applied in certain situations.
  - Part B applies to **professional accountants in public practice.**
  - Part C applies to **professional accountants in business.**

# Part A – Fundamental principles

Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework that professional accountants shall apply to:

- a. identify threats to compliance with the fundamental principles;
- b. evaluate the significance of the threats identified;
- c. apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
  - Safeguards are necessary when the threats are not at a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is not compromised.

# Conceptual framework approach

- A conceptual framework requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary.
- When an accountant identifies threats to compliance with the fundamental principles and determines that they are not at an acceptable level, he/she shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level.



# **The IFAC Code of Ethics for Professional Accountants fundamental principles for ALL accountants:**

1. Integrity (Sec. 110)
2. Objectivity (Sec. 120)
3. Professional Competence and Due Care (Sec. 130)
4. Confidentiality (Sec. 140)
5. Professional Behaviour (Sec. 150)

# Principles

**1. Integrity:** To be straightforward and honest in all professional and business relationships.

## Principles (Continued)

**2. Objectivity:** To not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

In the auditing sense bias is associated with money and personal association, e.g. if possible gains of wealth, prospects of a better income or personal relationships as with family or friends are involved, this may bias the auditor's work. There exist religious and cultural biases that may also affect an auditor's work and these biases have been well studied.

## Principles (Continued)

### **3. Professional Competence and Due Care:**

To maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

## Principles (Continued)

- 4. Confidentiality:** To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, 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, nor use the information for the personal advantage of the professional accountant or third parties.
- 5. Professional Behaviour:** To comply with relevant laws and regulations and avoid any action that discredits the profession.

# Disclosure of confidential information

May be disclosed when disclosure is authorised by the client, required by law (e.g. evidence in legal proceedings), where there is a professional duty or right to disclose (such as in a peer review quality control programme) or to comply with technical standards or ethics requirements.

# **Professional behaviour that discredits the profession example**

In marketing and promoting themselves and their work, professionals should be honest and truthful and not:

- make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or
- make disparaging references or unsubstantiated comparisons to the work of others.

# Threats and safeguards

**(no longer related just to Independence, but to ethics)**

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

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



# Self-interest threat

*A self-interest threat* occurs when an auditor could benefit from a financial interest in, or other self-interest conflict with, an assurance client.

# Self-interest threats circumstances (in Part B)

- A **financial interest** in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.
- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- Contingent fees relating to an assurance engagement.
- Discovering a significant error when evaluating the results of a previous professional service performed by a member of the professional accountant's firm.

# Self-review threat

*Self-review threat* – occurs when (1) results of a previous engagement needs to be re-evaluated in reaching conclusions on the present assurance engagement or (2) when a member of the assurance team previously was an employee of the client (especially a director or officer) in a position to exert significant influence over the subject matter of the assurance engagement.

## **Self-review threats circumstances (in Part B)**

- Reporting on the operation of financial systems after being involved in their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the assurance team being, or having recently been, a director or officer of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
- Performing a service for a client that directly affects the subject matter information of the assurance engagement.

# Advocacy threat

***An advocacy threat*** – occurs when a member of the assurance team promotes, or seems to promote, an assurance client's position or opinion. That is, the auditor subordinates his judgement to that of the client.

Examples of circumstances that create advocacy threats:

Selling, underwriting or otherwise dealing in financial securities or shares of an assurance client.

Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

# Familiarity threat

***Familiarity threat*** – occurs when an auditor becomes too sympathetic to the client's interests because he has a close relationship with an assurance client, its directors, officers or employees.

## **Familiarity threats circumstances (in Part B)**

- Immediate family member or close family member who is a director, officer or influential employee of the assurance client.
- A member of the assurance team having a close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
- Acceptance of gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

# Immediate family member – US classes

Under PCAOB's Rule 3501 Definitions, 'the term "immediate family member" means a person's spouse, spousal equivalent and dependents'.

US classes



# Intimidation threat

***Intimidation threat*** – occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

# Examples of intimidation threats

- Being threatened with dismissal from a client engagement.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- An audit client indicating that it will not award a planned non assurance contract to the firm if the firm continues to disagree with the client's accounting treatment.
- A professional accountant feeling pressured to agree with the judgement of a client employee because the employee has more expertise on the matter in question.
- A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

# Safeguards

Safeguards that may eliminate or reduce such threats to an acceptable level fall into two broad categories:

1. Safeguards created by the profession, legislation or regulation
2. Safeguards in the work environment.

## **Safeguards created by the profession, legislation or regulation include:**

- Educational, training and experience requirements to become a certified member of the profession.
- Continuing education requirements.
- Professional accounting, auditing and ethics standards.
- Disciplinary processes.
- Peer review of quality control.
- Professional rules or legislation governing the independence requirements of the firms.

## **Firm-wide safeguards in the work environment may include:**

- Leadership that stresses the importance of compliance with the fundamental principles and the duty to act in the public interest.
- Monitor and implement quality control of engagements.
- Documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats and apply safeguards.
- A disciplinary mechanism to promote compliance with policies and procedures.

## **Examples of engagement-specific safeguards in the work environment**

- Having a professional accountant who was not a member of the assurance team review the assurance work performed or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Rotation of senior assurance team personnel.

# Part B contents from Ethics Standard

## **PART B – PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE**

Section 200 Introduction .....

Section 210 Professional Appointment .....

Section 220 Conflicts of Interest .....

Section 230 Second Opinions .....

Section 240 Fees and Other Types of Remuneration .....

Section 250 Marketing Professional Services .....

Section 260 Gifts and Hospitality .....

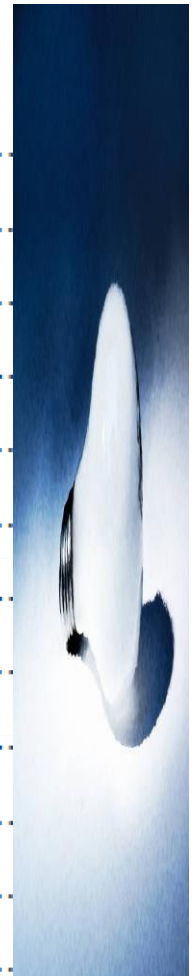
Section 270 Custody of Client Assets .....

Section 280 Objectivity – All Services .....

Section 290 Independence – Audit and Review Engagements .....

Section 291 Independence – Other Assurance Engagements .....

Interpretation 2005–1 .....



# Professional accountant in public practice

**A professional accountant in public practice** is a professional accountant, irrespective of functional classification (for example, audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.



# Professional appointment

Engagement acceptance – The principles of professional competence and due care imposes an obligation on a professional accountant in public practice to provide only those services that they are competent to perform.

# Replacing an existing auditor

- An auditor who is asked to replace another auditor, or who is considering a new engagement for a company currently audited by another auditor must consider whether there are any reasons, professional or otherwise, for not accepting the engagement.
- Determining possible reasons for not accepting a new client may require direct communication with the existing auditor to establish the facts and circumstances regarding the proposed change in auditors.

# Safeguards for accepting an audit engagement

Safeguards to deal with a threat to due professional care include:

- before accepting the engagement state that contact with the existing auditor will be made;
- asking the existing accountant to provide known information on any facts or circumstances that the proposed accountant needs to be aware of before deciding whether to accept the engagement;
- if unable to communicate with the existing auditor, the proposed auditor should obtain necessary information from other sources.

# Conflicts of interest

An auditor should develop procedures to identify circumstances that would lead to a conflict of interest and apply safeguards when necessary to eliminate the threats.

## Conflicts of interest (Continued)

- For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client.
- Possible safeguards include notifying the client of the audit firm's activities that may represent a conflict of interest or the use of separate engagement teams.

# Second opinions

- Sometimes a professional accountant in public practice is asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances on behalf of a company that is not an existing client. This may be a threat to professional competence and due care.
- Possible safeguards include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

# Fees and other types of remuneration

- A professional accountant in public practice may quote whatever fee is deemed appropriate. However, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.
- Accepting a referral fee or commission relating to a client creates a self-interest threat to objectivity and professional competence and due care.

# Marketing professional services

When a professional accountant in public practice solicits new work through advertising or other forms of marketing, there may be potential threats to compliance with the fundamental principles.



# Marketing professional services (Continued)

- A self-interest threat to compliance with the principle of professional behaviour is created if services, achievements or products are marketed in a way that is inconsistent with that principle.
- The accountant shall be honest and truthful, and not make exaggerated claims for services offered, qualifications possessed or experience gained; or make disparaging references or unsubstantiated comparisons to the work of another.

## Example of bad advertising

‘At our firm we believe the financial success of any business requires regular monitoring and attention to the smallest detail. Without the objective oversight of a practiced eye, huge opportunities can slip by unnoticed, and minor problems can quickly evolve into significant issues. That’s why the experts at our firm maintain a close relationship with our clients all year round, rather than merely reviewing financial records annually’.

# Gifts and hospitality

- A self-interest threat to objectivity may be created if a gift from a client is accepted; intimidation threats to objectivity may result from the possibility of such offers being made public.
- If a reasonable and informed third party, weighing all the specific facts would consider specific gifts or hospitality trivial and inconsequential, the offers would be considered part of the normal course of business.

# Custody of client assets

- To safeguard against a self interest threat to objectivity, a professional accountant in public practice entrusted with money (or other assets) belonging to others should:
  - Keep such assets separately from personal or firm assets.
  - Use such assets only for the purpose for which they are intended.
  - At all times be ready to account for those assets, and any income, dividends or gains generated.
  - Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

## Objectivity – All services

- Are there threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or directors, officers or employees?
- A public practice accountant who provides assurance services must be independent of the assurance client. Both independence of mind and independence in appearance are necessary if the auditor is to express an unbiased opinion without conflict of interest or undue influence.

## SECTION 290 INDEPENDENCE – AUDIT AND REVIEW ENGAGEMENTS CONTENTS

**Paragraph**

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## Illustration 3.3 Code of Ethics Section 290 on Independence

# Independence Sec. 290

## SECTION 290 INDEPENDENCE – AUDIT AND REVIEW ENGAGEMENTS CONTENTS

### *Paragraph*

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Legal Services	290.209
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Corporate Finance Services	290.216
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Compensation and Evaluation Policies	290.228
Gifts and Hospitality	290.230
Actual or Threatened Litigation	290.231
Reports that Include a Restriction on Use and Distribution	290.500

Illustration 3.3 Code of Ethics Section 290 on Independence (Continued)

# European Union auditor independence

- Member States shall prescribe that auditors shall not carry out **statutory audits** if they are not independent in accordance with the law of the Member State which requires the audit.
- An auditor must be independent from his audit client both in mind and appearance. The auditor should not audit a client if there are any financial, businesses, employment or other relationships between them that a 'reasonable and informed third party' would conclude compromised independence.



# Independence in the Sarbanes–Oxley Act of 2002

## TITLE II – AUDITOR INDEPENDENCE

Sec. 201. Services outside the scope of practice of auditors.

Sec. 202. Pre-approval requirements.

Sec. 203. Audit partner rotation.

Sec. 204. Auditor reports to audit committees.

Sec. 205. Conforming amendments.

Sec. 206. Conflicts of interest.

Sec. 207. Study of mandatory rotation of registered public accounting firms.

Sec. 208. Commission authority.

Sec. 209. Considerations by appropriate State regulatory authorities.

## **PCAOB Ethics and Independence rules concerning independence, tax services and contingent fees – US Classes**

- Not independent if the audit firm provided any service or product to an audit client for a contingent fee or a commission.
- Not independent if the firm provided assistance in planning, or provided tax advice on, certain types of potentially abusive tax transactions to an audit client or persons employed by that client and must seek audit committee approval for any tax services.
- Firms must be independent of their audit clients throughout the audit period.

# Independence – Mind and appearance

The conceptual framework involves two views of independence to which the auditor must comply:

1. Independence of mind is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.
2. Independence in appearance is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, integrity, objectivity or professional scepticism has been compromised.

# Independence – Assurance engagements

The Code emphasises that during audit engagements it is in the public interest and required that members of audit teams must be independent of audit clients.

# Documentation of independence

The professional accountant must document conclusions regarding compliance with independence requirements, and the substance of any relevant discussions that support those conclusions. E.g.

- The nature of the threat and the safeguards in place
- If no safeguards are necessary, the rationale.

# Engagement period

Independence from the audit client is required both during the engagement period and the period covered by the financial statements.

# Financial interests

The self-interest threat created when an auditor, her firm, or a member of her immediate family has direct or material indirect financial interest in an audit client is such that no safeguards could reduce it to an acceptable level.

A loan, or a guarantee of a loan, to a member of the audit team, or a member of that individual's immediate family, or the firm from an audit client that is a bank or similar institution may create a threat to independence.

# Business, family and personal relationships

A close business relationship between a firm, or a member of the audit team, or a member of that individual's immediate family and the audit client or its management, arises from a commercial relationship or common financial interest and may create self-interest or intimidation threats. The business relationship must not be entered into because NO safeguards would be sufficient and the individual with the relationship must be removed from the audit team.



# Provision of non-assurance services to audit clients

- Providing non-assurance services to assurance clients may create threats to the independence of the firm or members of the audit team.
- Providing certain non-assurance services to an audit client may create a threat to independence so significant that no safeguards could reduce the threat to an acceptable level.
- Examples: services that assume a management responsibility, bookkeeping, resolution of a tax dispute, internal audit services, IT systems, valuation, legal, recruiting services, corporate finance.

# Independence in the Sarbanes–Oxley Act of 2002

Prohibited non-audit service contemporaneously with the audit include:

1. bookkeeping or other services related to the accounting records or financial statements of the audit client;
2. financial information systems design and implementation;
3. appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
4. actuarial services;
5. internal audit outsourcing services;
6. management functions or human resources;
7. broker or dealer, investment adviser or investment banking services;
8. legal services and expert services unrelated to the audit;
9. any other service that the Board determines, by regulation, is impermissible.

US classes

# Fees

Professional fees should be a fair reflection of the value of the professional service performed for the client, taking into account the skill and knowledge required, the level of training and experience of the persons performing the services, the time necessary for the services and the degree of responsibility that performing those services entails. The IESBA Ethics Code discusses threats to independence in pricing auditing services in terms of size, whether fees are overdue, and contingent fees.

## Size of client fees and unpaid fees

- If an audit client is a public interest entity and, for two consecutive years, the total fees from the client represent more than 15% of the total fees received by the audit firm, the firm must disclose to the audit client that fact and discuss safeguards it will apply.
- The Code warns that a self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time.

# Compensation and evaluation policies

A self-interest threat is created when a member of the audit team or a key audit partner is evaluated on or compensated for selling non-assurance services to that audit client.

## Actual or threatened litigation

- ✓ When litigation takes place, or appears likely, between the audit firm or a member of the audit team and the audit client, self-interest and intimidation threats are created.
- ✓ If safeguards do not reduce the threats to an acceptable level, the only appropriate action is to withdraw from, or decline, the audit engagement.

# **Independence requirements for assurance engagements that are not audit or review engagements**

The IESBA Code of Ethics for Professional Accountants Section 291 (see Illustration 3.4 for contents) addresses independence requirements for assurance engagements that are not audit or review engagements.

# Examples in Part C from Ethics Standard

## **PART C – PROFESSIONAL ACCOUNTANTS IN BUSINESS**

Section 300 Introduction .....

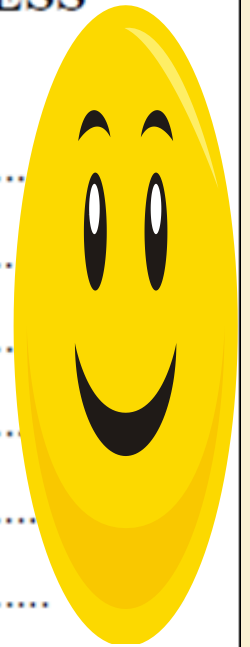
Section 310 Potential Conflicts .....

Section 320 Preparation and Reporting of Information .....

Section 330 Acting with Sufficient Expertise .....

Section 340 Financial Interests .....

Section 350 Inducements .....





## Part C – Employees, management, volunteers

- Part C of the IESBA Code describes how the conceptual framework contained in Part A applies in certain situations to a salaried employee, a partner, director, an owner manager or a volunteer (professional accountant in business).
- Part C also addresses circumstances in which compliance with the fundamental principles may be compromised by potential conflicts, preparation and reporting information, acting with sufficient expertise, financial interests and inducements.

A professional accountant in business shall not knowingly engage in any business, occupation or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles.

## Potential conflicts

- There may be times when responsibilities to an employing organisation and professional obligations to comply with the fundamental principles are in conflict. Pressure may be applied to act contrary to law or regulation or to technical or professional standards, or facilitate unethical or illegal earnings management strategies.

## Other sections of Part C

- There are other sections in Part C which address specific aspects of the work of professional accountants in business. These sections include discussion of:
  - preparation and reporting of information (Sec. 320);
  - acting with sufficient expertise (sec. 330);
  - financial interests (Sec. 340);
  - inducements (Sec. 350).
- We will not discuss these sections in this chapter.

# Enforcement of ethical requirements

- In many countries an auditor who violates the ethical standard may be disciplined by law or by the professional organisation. The penalties range from a reprimand to expulsion or fine to fines to prison.
- International Ethics Standards Board of Accountants (IESBA) has no authority to require disciplinary action for violation of the Code of Ethics.

# Thank you for your attention

## Any Questions?