Professional Ethics in Auditing

(Relevant to Paper III – PBE Auditing and information systems)
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Introduction

The general public demand professional accountants[1] maintain a high ethical standard in order to maintain public confidence in the accountancy profession. Professional accountants are required to comply with the Code of Ethics for Professional Accountants issued by the Hong Kong Institute of CPAs. Any member that fails to comply is liable to be investigated by the Institute, resulting in possible disciplinary action such as an order to remove the name of the member from the Institute's membership register.

It is suggested that auditing candidates study only Parts A and B of the Code as Parts C and D are mostly irrelevant to auditing.

Part A Fundamental Principles

Part A establishes the fundamental ethical principles that apply to all members as well as guidance on the threats and safeguards relating to those fundamental principles. Professional accountants are required to abide by the following five fundamental principles:

(a) *Integrity*
A professional accountant should be straightforward and honest in all professional and business relationships.

(b) *Objectivity*
A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional Competence and Due Care*
A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques.

(d) *Confidentiality*
A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should 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.

(e) *Professional Behaviour*
A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

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[1] A professional accountant is a person who is member of the Hong Kong Institute of Certified Public Accountants

A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles. Many threats fall into one of the following five categories:

(a) Self-interest threat, when a professional accountant, or an immediate or close family member, has a financial or other interests

(b) Self-review threat, when a professional accountant re-evaluates his own judgement

(c) Advocacy threat, when a professional accountant promotes an opinion that compromises his own objectivity

(d) Familiarity threat, when a professional accountant, due to a close relationship, becomes too sympathetic to the interests of others

(e) Intimidation threat, when a professional accountant is threatened from acting objectively

Other than clearly insignificant threats, a professional accountant should apply safeguards to either eliminate or reduce the threat to an acceptable level so that the fundamental principles are not compromised. Safeguards fall into two categories:

(a) Safeguards created by the profession, legislation or regulation, such as professional standards, continuing professional development, and education and training
(b) Safeguards in the work environment

The purpose of safeguards is to increase the likelihood of identifying or deterring unethical dilemmas. However, if a professional has violated the Code without knowing he or she has done so, once discovered the professional accountant must make immediate remedial action, including setting up further safeguards. The violation may or may not compromise compliance dependent on the nature and significance of the matter.

Part B Professional Accountants in Public Practice

Part B of the Code illustrates how the fundamental principles are applied to professional accountants in public practice (auditors):

(a) Professional Appointment

1. *Client acceptance*
   An auditor should consider whether acceptance of a new client would create any threats to compliance with the fundamental principles. Where it is not possible to reduce the threats to an acceptable level, an auditor should not enter into the client relationship.

   Examples of potential threats include:
   - The client is suspected of being involved in illegal activities
   - The auditor has unresolved questionable issues with the client

2. *Engagement acceptance after client has been accepted*
   Before accepting an engagement, the auditor should consider whether acceptance would create any threats to compliance with the fundamental principles.

Examples of potential threats include:
- The auditor does not possess the competencies necessary to properly carry out his or her duties
- The auditor prepared the original data used to generate records that are the subject matter of the engagement

3. *Changes in a professional appointment*
   An auditor who is to replace an existing auditor should determine whether there are any professional reasons for not accepting the engagement.

   Examples of potential threats include:
   - Whether the auditor has received professional clearance from the existing auditor
   - Whether an auditor accepts an engagement before knowing all the pertinent facts

(b) *Conflicts of Interest*
An auditor should be alert to any circumstances that could pose a conflict of interest.

Examples of potential threats include:
- When an auditor competes directly with a client
- When an auditor audits two clients, say Pepsi and Coca-Cola, whose interests are in conflict

(c) *Second Opinions*
An auditor may be asked to give a second opinion on an entity that is not an existing client.

Examples of potential threats include circumstances where the second opinion is:
- not based on the same set of facts that were made available to the existing auditor
- based on inadequate evidence

(d) *Fees and Other Types of Remuneration*
There may be threats to compliance with the fundamental principles arising from the level of fees quoted.

Examples of potential threats include:
- The audit fee is too low so that a proper audit cannot be conducted
- Undue dependence on total fees from a single client

(e) *Marketing Professional Services*
When an auditor solicits new work through marketing, there may be potential threats to compliance with the fundamental principles.

Examples of potential threats include:
- An exaggerated claim for services offered, qualifications possessed or experience gained
- Improper use of the CPA logo

(f) *Gifts and Hospitality*
An auditor, or an immediate or close family member, is offered gifts or hospitality from a client, and the value of these gifts or hospitality is not insignificant.

Examples of potential threats include:
- If the gift from a client is accepted
- If the gift or hospitality becomes a form of bribery in return for favours (this is also a criminal offence)

(g) *Custody of Client Assets*
An auditor should not keep custody of client monies or any other assets unless permitted by law.

Examples of potential threats include:
- The auditor intermingles client and firm monies
- The auditor has not complied with the law regarding the holding of client assets

(h) *Objectivity – All Services*
An auditor should consider whether there are interests in, or relationships with, a client or directors, officers or employees.

Examples of potential threats include:
- A close family friend is an employee of the client
- The auditor went to school with the client managing director

(i) *Independence – Assurance Engagements*
On assurance engagements, the intended users of the financial statements require the auditor to be independent from the assurance client. The auditor must be both independent in mind and independent in appearance.

Examples of potential threats include:
- Members of the audit engagement team are not independent of the client
- The client is able to exert some influence over an audit engagement team member

The full version of the Code can be found in the Members' Handbook at www.hkicpa.org.hk/std/hbk/content.php

Solving Ethical Dilemmas

There are a number of models that help professional accountants deal with ethical dilemmas. One such model which is very thorough in solving ethical dilemma facing professional accountants is the seven-step American Accounting Association model. This is summarized as follows:

Step 1. Determine the facts
Define the problem, including identifying all stakeholders involved.

Step 2. Define the ethical issue(s)
Using the facts to identify the ethical issues requires an in-depth understanding of the Code.

Step 3. Identify the major principles, rules and values

From step 2, it should become clear what the major principles, rules and values involved are. Apart from the Code, identify whether other laws, rules or regulations are also involved.

Step 4. Specify the alternatives
List all possible alternatives from doing nothing to resigning.

Step 5. Compare steps 3 and 4 to see if there is a clear decision.

Step 6. Assess all the consequences for the remaining possible decisions.

Step 7. Make your decision, which must be in compliance with the Code, laws, rules and regulations.

References

HKICPA Code of Ethics for Professional Accountants (effective June 2006)
Ethics in Management: A Practical Guide for Professional Accountants, HKICPA (1997)