Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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PART D: ETHICS AND VALUES

D.2: Ethics and Agreeing the terms of the Engagement

The behavior of organizations and the people who work for them is controlled by laws and regulations. People may choose to break the law or breach regulations, but improper behavior is punished if it is discovered. A minimum standard of acceptable behavior in business should be compliance with laws and regulations

Many organizations recognize the importance of achieving much higher standards of conduct, and that they should act in accordance with an established code of ethics

Notes:

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D.2.1. Law, ethics and morality

Laws

Laws and regulations seek to control our actions in many different aspects of our lives. Many laws and regulations apply to business activity: company law, contract law, employment law, competition law, and so on, are all features of business life.

Business organizations and their employees must comply with laws and regulations or face the threat of judicial or regulatory action if their breach of the rules is discovered.

Laws and regulations set a minimum standard of behavior

Morality

Morality is concerned with personal beliefs about what is right or wrong. Personal views of right and wrong may be influenced by religion, but individuals do not need to be religious to have their own beliefs about 'right' and 'wrong'

Values

The morality of an individual is based on their personal values. Personal values are an individual's beliefs about right and wrong, and about what is desirable and what is undesirable

Values can be the basis for ethical views and actions.

Although individuals have their personal morality and values, organizations may also try to develop their own corporate values, which employees are expected to uphold and apply in their work

Ethics

Ethics are standards or rules of behavior and represent a view about how people should conduct themselves. Ethical standards usually include the view that there should be compliance with laws and regulations, but they also expect standards of behavior that go beyond the law

Ethical values of individuals are based on personal values. Individuals may have personal ethical standards of behavior, based on their personal morality. In this respect, ethics and morals are similar. However, morality is a view of right and wrong: ethics is a view about how to behave

Individuals and organizations may have different personal values and ethical views. Here are just two examples

One ethical view	A different ethical view
I believe in working hard and doing the best that I can in my job.	I am paid to do a job, and I should do enough to justify the money that I am paid.
I believe in being completely open and honest in my dealings with other people.	I believe in getting on well with people, but I prefer to keep my views to myself and I don't share information unless I am asked.

Differences between law, ethics and morality

Although they are connected, there are differences in the way that laws, ethics and morality affect our behavior at work

Laws and regulations	These establish ways in which the government requires us to behave.
Ethical codes	These establish ways that members of an organisation or professional are required to behave. Ethical standards should include compliance with laws and regulations, but extend into aspects of behaviour that are not governed by laws.
Morality and moral codes	These are a personal sense of right and wrong, and how the individual should behave. Individuals may consider some ethical standards, laws and regulations to be 'wrong'.

Corporate values and ethics	
A company has a large number of suppliers who operate as small family businesses. All purchases are on 30 days' credit, but the company often takes much more than 30 days to pay invoices. This frequently creates financial difficulties for some suppliers.	It is not illegal to defer payments to suppliers for as long as possible. However, it is not ethical business practice.
A large international company uses offshore financial subsidiaries to avoid large payments of tax in the countries where they have business operations.	Global companies employ tax experts to devise schemes of tax avoidance, whereby tax payments are kept to a minimum without actually breaking any laws. They would argue that since the tax avoidance schemes are legal, they are not unethical and the companies should be doing as much as they can to maximise profits for their shareholders.

D.2.2. The importance of ethical behavior for accountants

Professional associations, including accountants, have a code of ethics that their members are required to follow. A reputation for high ethical standards reinforces public trust in the accountancy profession

Each professional accountancy body has its own code of ethics for members. However, as is the case with the CASL Code of Ethics, most of these codes are based on the International Code published by IFAC and so are very similar.

There are various reasons why accountants should behave ethically.

- ✓ Ethical behavior includes compliance with laws and regulations, and accountants are expected to act within the law.
- ✓ The profession requires members to conduct themselves and provide services to the public according to certain standards. By upholding these standards, the profession's reputation and standing is protected.
- ✓ An accountant's ethical behavior serves to protect the public interest.
- ✓ Consequences of unethical behavior include disciplinary action against the accountant by their employer or professional body.
- ✓ Accountants employed in the public sector have a duty to protect tax-payers' money

Aspect of accountancy work	Need for ethical behaviour
Financial reporting: keeping accurate accounting records	Other people rely on the 'accuracy' of the financial statements produced by accountants. Published financial statements should give a true and fair view of the financial performance and position of a company, so that the company owners (shareholders) can take informed decisions about their investment. Governments require honest financial statements and accounting records, so that businesses pay the correct amount of tax that they owe.

Aspect of accountancy work	Need for ethical behaviour
Technical work and specialist work	An employer may rely on an accountant's technical knowledge and expertise, for example in making investment decisions or deciding how much to pay for a target company in a takeover bid. Accountants need to have the appropriate knowledge and technical expertise to do the work competently.
Accountants deal with money and payments	This is an aspect of business where fraud and other crimes are most likely to occur. Employers need to be able to trust accountants with their money!

D.2.3. Fundamental principles of professional ethics

There are five fundamental principles of professional ethics for accountants: integrity; objectivity (linked to independence); professional competence and due care; confidentiality and professional behavior

Professional bodies expect all members to comply with their code of ethical behavior because ethical conduct is a feature of professions. This makes professions stand out as different from other lines of work. People can expect ethical behavior from accountants, and this is a reason why they should want to use the services of accountants and why they should be able to trust the integrity of accountants

Fundamental principles of professional ethics	
Integrity	Members shall be straightforward and honest in all their professional and business relationships.
Objectivity	Members shall not allow bias or conflicts of interest or undue influence of other people to override their professional or business judgement.

Professional competence and due care	Members have a continuing duty 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.
Confidentiality	Members shall respect the confidentiality of information acquired as a result of professional and business relationships. They should not disclose any such information to third parties without proper and specific authority, or unless there is a legal or professional right or duty to disclose the information. Confidential information acquired as a result of professional and business relationships must not be used for the personal advantage of the member or a third party.
Professional behaviour	Members shall comply with relevant laws and regulations and avoid any action that discredits the profession.

- **Integrity**

The principle of integrity requires accountants to be straightforward and honest in their professional and business relationships. Integrity also implies dealing fairly with other people and being truthful

This means for example that an accountant should not be associated with reports or other communications that:

- ✓ They believe contain false or misleading information
- ✓ Omit or obscure information, which makes the communication misleading

A person who always acts with integrity will be trusted by the people they deal with regularly. Integrity in their business and professional relationships by accountants will also enhance the trust of the general public in the profession

❑ Objectivity

Objectivity is the principle that all professional and business judgements should be made fairly:

- ✓ On the basis of an independent and intellectually honest appraisal of information
- ✓ Free from all forms of prejudice and bias
- ✓ Free from factors which might affect impartiality, such as pressure from a superior, financial interest in the outcome, a personal or professional relationship with one of the parties involved, or a conflict of interest

Objectivity is a state of mind. However, in some situations the preservation of objectivity needs to be demonstrated by independence from the influence of people who might impair their objectivity.

In other words, there are occasions when it is not sufficient to be objective. It is necessary to demonstrate independence as evidence of objectivity

❑ Professional competence and due care

Accountants have an obligation to their employers and clients to know what they are doing – and to do it right! The principle of professional competence and due care imposes an obligation on accountants to:

- ✓ Maintain their professional knowledge and skill at the level required to ensure that their clients or employers receive competent professional service
- ✓ Act diligently, in accordance with applicable technical and professional standards when providing professional services

Requirement	Comment
To provide a competent professional service	This requires the exercise of sound judgement in applying professional knowledge and skill.
Maintenance of professional competence	This requires continuing awareness and understanding of relevant technical, professional and business developments. Continuing professional development (CPD) develops and maintains the capabilities that enable an accountant to perform competently.
To act diligently	Diligence means acting in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.
To act with due care	Due care means that accountants should take the degree of care expected from a person in their position. For example, having agreed to do a task, an accountant has an obligation to carry it out to the best of their ability, within a reasonable timescale and with proper regard for technical and professional standards.

- **Confidentiality**

The principle of confidentiality imposes an obligation on a professional accountant to refrain from:

(a) Disclosing to anyone outside the firm (or employer organization) any confidential information that is acquired as a result of professional and business relationships, without proper and specific authority. The only exceptions are in circumstances where the accountant has a legal duty, or a professional right or duty, to disclose the information.

(b) Using confidential information to their personal advantage or the advantage of a third party

Confidentiality principle	Practical applications of the principle	
Information about the business affairs of a client or an employer is likely to be confidential if it is not a matter of public knowledge.	An accountant should maintain confidentiality of information disclosed by a prospective client or employer.	The restriction on using confidential information means not using it for any purpose other than that for which it was legitimately acquired.
Confidential information should not be disclosed to people the accountant knows personally, associates and people with whom the accountant has long-established business relationships.	An accountant should maintain confidentiality of information within the firm or organisation that employs them. They should take all reasonable steps to ensure that staff who are under their control respect the principle of confidentiality.	The need to comply with the principle of confidentiality continues even after the end of relationships between an accountant and a client or employer.

The ethical principle of confidentiality is another reason why the accountancy profession is trusted to provide services to clients or employers

Exceptions to the rule on confidentiality

Confidentiality is an important fundamental ethical principle but there are circumstances where the law allows or requires that confidentiality to be breached.

- ✓ Where disclosure is permitted by law and is authorized by the client or employer
- ✓ Where disclosure is required by law, for example to provide documents or other evidence for legal proceedings
- ✓ Where disclosure is required by law of actual or suspected money laundering or terrorist financing
- ✓ Where there is a professional right or duty to disclose information, which is in the public interest and is not prohibited by law

- ❑ **Professional behavior**

The principle of professional behavior imposes an obligation on members to comply with relevant laws and regulations and avoid any action that may bring disrepute to the profession.

Accountants who work in practice should be honest and truthful when advertising their services. They can bring the profession into disrepute by making exaggerated claims about services, their qualifications and experience, or if they make disparaging references or unsubstantiated comparisons to the work of other accountancy firms

Professional ethics for accountants in practice

Principle	Example of unethical behaviour
Integrity	An accountant obeys an instruction from an employer to include a false sale in the annual financial reports. The accountant creates a false sales order and false records indicating the provision of a service to a (non-existent) customer. The purpose of this is to improve the reported profit for the year, so that the company's bank will lend more money that the company needs to avoid insolvency.
Objectivity	An accountant is asked to advise the board of directors about the selection of a supplier for a major contract. The company has received a tender (bid) from each of three different suppliers, and the board would like advice about which is the most attractive. The accountant recommends that the board should accept a bid from one of the three suppliers, not mentioning that their father owns the company.
Confidentiality	An accountant has been working on a highly confidential project with a major customer of their employer. A competitor wants to win the project work and offers the accountant a job at a much increased salary. The accountant accepts the offer, and takes confidential files and information with them to the new employer.
Professional competence and due care	An accountant acts as treasurer for their company, and in this role commits the company to a number of complex financial derivatives transactions. The accountant has no previous experience with financial derivatives and very little understanding of them. The company makes large losses on the transactions.
Professional behaviour	An accountant may advise and assist a client with money laundering (a criminal activity).

D.2.4. Ethical threats

There are threats that may persuade accountants to act in an unethical way, in breach of the fundamental principles and their professional code: self-interest; self-review; advocacy; familiarity and intimidation

Professional accountancy bodies are aware that circumstances will arise that are threats to professional ethical behavior. There is a risk that the accountant will not behave properly, and in accordance with the fundamental principles, because of the nature of the threat

Threat	
Self-interest threat	Financial or other interests may inappropriately influence the member's judgement and behaviour. For example, excessive dependence on fees from one particular client may affect the judgement of an accountant in practice: the accountant may be persuaded too easily to accept the arguments and explanations of the client.
Self-review threat	If an accountant is asked to review and re-evaluate work that they have done for a client in the past, or if they are asked to re-evaluate a judgement that they made in the past, they will be tempted to confirm that their previous work or judgement was correct.
Advocacy threat	An accountant may be asked to promote a position or opinion in support of a client or employer. There is a risk that the accountant will do this to an extent that their subsequent objectivity is compromised.
Familiarity threat	Due to close or personal relationships, an accountant may become too sympathetic to the interests and explanations of people in their organisation or in a client organisation. For example, familiarity with an audit client can threaten the objectivity of an auditor.
Intimidation threat	An accountant may be threatened or warned by a colleague or client about action that the colleague or client will take unless the accountant makes a particular judgement or action. For example, a client of an audit firm may threaten to sue unless the audit firm reaches a decision that favours the client. A boss may threaten an accountant with an unfavourable performance review unless the accountant accepts everything the boss tells them, without exception.

D.2.5. Dealing with threats to professional ethical behavior

Accountants should always follow the fundamental ethical principles in their judgements and actions and should try to avoid excessive threats to their ethical behavior

There are two broad categories of safeguards that are used to reduce threats to professional ethical behavior

Safeguards created by the profession or by legislation and regulation	Safeguards in the work environment
Education, training and experience, as requirements for entry into the profession	Rotation of personnel to avoid increasing familiarity and opportunities for collusion in fraud
Continuing professional development (CPD)	
Professional standards: ethical code	Quality controls over work standards, and internal audits of quality controls
Disciplinary measures for breach of ethical code	

Conflicts of interest

A conflict of interest occurs for accountants when they have two different loyalties or commitments which may occasionally conflict with each other.

The most common conflict of interest involves self-interest. This occurs when the personal interests of an individual may differ from the interests of the individual's employer or client

Self-interest threats: financial threats

There are a number of ways in which an accountant in business could gain financially from their activities for an employer – and many of these might pose a self-interest threat to fundamental ethical principles such as integrity, confidentiality, or (especially) objectivity

Acceptance of gifts

A common threat to independence and objectivity of an accountant (and the appearance of independence and objectivity) is accepting gifts, services, favors or hospitality from parties who may have an interest in the outcome of the accountant's work

Offering inducements

Sometimes, accountants in business are expected to offer inducements to influence the judgement of others or a decision-making process, or to get confidential information. Accountants in business must not offer inducements to improperly influence the professional judgement of a third party

Threat to duty of professional competence and due care

Accountants in business should only undertake significant tasks for which they have, or can obtain, sufficient experience. However, if the accountant has adequate support, usually in the form of supervision from an individual who has the necessary training and experience, then it may be possible to undertake appropriate significant tasks. An accountant in business should not intentionally mislead an employer about the level of expertise or experience they have, and they should seek appropriate expert advice and assistance when required

Potential threats to the principle of competence and due care include:

- Time pressure (when there may not be enough time to complete a task properly)
- Insufficient or inaccurate information
- Lack of resources (eg equipment or help)
- The accountant's lack of experience, knowledge or training

These threats may not be significant if the accountant is working as part of a team, or under supervision, or on a comparatively low-level task. If they are significant, however, the accountant may need to apply safeguards to eliminate them or reduce them to an acceptable level.

These could include some of the following:

- ✓ Obtaining additional advice or training
- ✓ Ensuring they have enough time to do their work
- ✓ Getting help from someone with the relevant knowledge
- ✓ Consulting with superiors, independent experts or the relevant professional body

D.2.6. Ethical views and theories

There are different ethical views. These include the deontological view, which judges individuals on whether they did their duty, and the teleological view, which judges individuals on the consequences of actions

Deontological and teleological views of ethics

When considering what is ethical and how to behave ethically there are two contrasting views, the deontological view and teleological view.

The deontological view (sometimes referred to as duty based ethics) is that whether an action is right or wrong depends on whether that the individual is doing their 'duty' or following the rules when they take that action, irrespective of the consequences of the action.

The teleological view (sometimes called consequentialism) is that an individual should be judged on the consequences of an action, even though the action might not be in accordance with applicable rules

Ethical theories

Ethical theories and models have been developed to help with resolution of ethical conflicts. One such model which uses a step by step approach is The American Accounting Association (AAA) model

Step 1 Establish the facts of the case.

Step 2 Identify the ethical issues in the case.

Step 3 Identify the principles and values related to the case, placing the decision in its social, ethical, and professional behavior context.

Step 4 Identify each alternative course of action ensuring all outcomes are considered, regardless of the principles and values identified in Step 3.

Step 5 Compare each of the alternative actions in Step 4 and see if they are in accordance with the principles and values identified in Step 3.

Step 6 Consider the consequences of each of the outcomes. Now the principles and values together with the consequences of each action have been considered.

Step 7 The decision is taken, bearing in mind the applicable principles and values and the possible outcomes

D.2.7. Agreeing the terms to the engagement

The terms of the audit engagement shall be agreed with management and recorded in an audit engagement letter

Preconditions for an audit

SLAuS 210 Agreeing the Terms of Audit Engagements states that the objective of the auditor is to accept or continue an audit engagement only when the basis on which it is to be carried out has been agreed by establishing whether the preconditions for an audit are present and confirming that there is a common understanding between the auditor and management of the terms of the engagement

To determine whether the preconditions for an audit are present, the auditor shall do the following:

(a) Determine whether the financial reporting framework is acceptable. Factors to consider include the nature of the entity, the purpose of the financial statements, the nature of the financial statements, and whether law or regulation prescribes the applicable financial reporting framework.

(b) Obtain management's agreement that it acknowledges and understands its responsibilities for the following:

(i) Preparing the financial statements in accordance with the applicable financial reporting framework

(ii) Internal control that is necessary to enable the preparation of financial statements which are free from material misstatement

(iii) Providing the auditor with access to all information of which management is aware that is relevant to the preparation of the financial statements, with additional information that the auditor may request, and with unrestricted access to entity staff from whom the auditor determines it necessary to obtain audit evidence

If these preconditions are not present, the auditor shall discuss the matter with management. The auditor shall not accept the audit engagement if:

- The auditor has determined that the financial reporting framework to be applied is not acceptable.
- Management's agreement referred to above has not been obtained

The audit engagement letter

The auditor shall agree the terms of the engagement with management or those charged with governance and these shall be recorded in an audit engagement letter or other suitable form of written agreement (SLAuS 210: paras. 9–10). This has to be done before the audit engagement begins so as to avoid misunderstandings regarding the audit

Form and content of the audit engagement letter

The audit engagement letter shall include the following:

- 'The objective and scope of the audit
- The auditor's responsibilities
- Management's responsibilities
- Identification of the applicable financial reporting framework for the preparation of the financial statements
- Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content'

Additional matters that may be included

The audit engagement letter may also make reference to the following:

- Elaboration of scope of audit, including reference to legislation, regulations, ISAs, ethical and other pronouncements
- Form of any other communication of results of the engagement
- The requirement for the auditor to communicate key audit matters in accordance with SLAuS 701 (where required)
- The fact that due to the inherent limitations of an audit and those of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs
- Arrangements regarding planning and performance, including audit team composition

- Expectation that management will provide written representations
- The expectation that management will provide access to all information to which management is aware that is relevant to the preparation of the financial statements
- Agreement of management to provide draft financial statements including all information relevant to their preparation in time to allow auditor to complete the audit in accordance with proposed timetable
- Agreement of management to inform auditor of facts that may affect the financial statements, of which management may become aware from the date of the auditor's report to the date of issue of the financial statements
- Fees and billing arrangements
- Request for management to acknowledge receipt of the letter and agree to the terms outlined in it
- Involvement of other auditors and experts
- Involvement of internal auditors and other staff
- Arrangements to be made with predecessor auditor
- Any restriction of auditor's liability
- Reference to any further agreements between auditor and entity
- Any obligations to provide audit working papers to other parties

Recurring audits

On recurring audits, the auditor shall assess whether the terms of the engagement need to be revised and whether there is a need to remind the entity of the existing terms (SLAuS 210: para. 13). The following factors may indicate that it would be appropriate to revise the terms of the engagement or remind the entity of the existing terms. As you may expect, these are likely to be identified in the course of a continuance assessment.

- Any indication that the entity misunderstands the objective and scope of the audit
- Any revised or special terms of the audit engagement
- A recent change of senior management
- A significant change in ownership
- A significant change in nature or size of the entity's business
- A change in legal or regulatory requirements
- A change in the financial reporting framework
- A change in other reporting requirements

Acceptance of a change in terms

A change in the terms of audit engagement prior to completion may result from:

(a) A change in circumstances affecting the need for the service

(b) A misunderstanding as to the nature of an audit or of the related service originally requested

(c) A restriction on the scope of the audit engagement, whether imposed by management or caused by circumstances

Chapter review questions

1. Behaving ethically is the minimum level of behavior expected from an individual in business.
   True
   False

2. Match each ethical principle to the correct definition.

   Ethical principles:
   (a) Integrity
   (b) Objectivity
   (c) Professional competence and due care
   (d) Confidentiality
   (e) Professional behavior

   Definitions:
   (i) Not allow bias, conflicts of interest or undue influence of others to override professional or business judgements.
   (ii) Have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives a competent professional service based on current developments in practice, legislation and techniques. Act diligently and in accordance with applicable technical and professional standards when providing professional services.
   (iii) Be straightforward and honest in all business and professional relationships.
   (iv) Comply with relevant laws and regulations and avoid any action that discredits the profession.
   (v) Respect the secrecy of information acquired as a result of professional and business relationships and do not disclose any such information to third parties without proper or specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties

3. Fill in the blank: ______________________ means that members should be straightforward and honest in all business and professional relationships

4. Give four examples of a familiarity threat for an accountant in practice

5. Fill in the gaps in the following sentences. A conflict of interest arises where you have a duty to _________ or more parties. Matters arise which mean you cannot continue to work for one party without ____________ the other
   A common example of conflict of interest is __________________

6. An engagement letter is only ever sent to a client before the first audit
   True
   False