"Pioneers in Professional Education"

CL 02 – Financial Reporting and Governance

Corporate Level

(Professional Ethics)

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Professional Ethics - 2023

Topic No 06

1. Ethical principles in financial reporting

The accounting profession is highly regarded and the public have a high level of trust in the information that accountants produce. It is therefore essential that accountants follow a code of ethics to ensure they always act in the best interests of stakeholders.

1.1 The Code of Ethics and fundamental ethical principles

The Code of Ethics for Professional Accountants issued by the Institute of Chartered Accountants of Sri Lanka (Latest edition 2023) identifies 05 fundamental principles most relevant to accountants in business involved in corporate reporting ***(Section 110.1 A1)***.

Principle	**Explanation**
Integrity	To be straightforward and honest in all professional and business relationships
Objectivity	To exercise professional or business judgment without being compromised by: • Bias • Conflict of interest or • Undue influence of, or undue reliance on, individuals, organizations, technology or other factors
Professional Competence and Due Care	To: • Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation • Act diligently and in accordance with applicable technical and professional standards
Confidentiality	To respect the confidentiality of information acquired as a result of professional and business relationships.
Professional Behavior	To: • Comply with relevant laws and regulations; • Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships, • Avoid any conduct that the professional accountant knows or should know might discredit the profession.

1.1.1 Fundamental Principles in detail

Integrity

Integrity involves **fair dealing**, **truthfulness** and having the **strength** of character to **act appropriately** even when facing pressure not to do so. Acting appropriately involves:

- Standing one's ground when confronted by dilemmas and difficult situations,
- Challenging others as and when circumstances warrant, in a manner appropriate to the circumstances.

When adhering to integrity a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

- Contains a materially false or misleading statement;
- Contains statements or information provided recklessly; or
- Omits or obscures required information where such omission or obscurity would be misleading.

Objectivity

A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

Professional competence and due care

Serving clients and employing organizations with professional competence requires the **exercise of sound judgment** in applying professional knowledge and skill when undertaking professional activities. Maintaining professional competence requires a **continuing awareness** and an understanding of relevant technical, professional, business and technology-related **developments**.

Acting diligently includes the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

Confidentiality

Need to respect the confidentiality of information obtained as a result of professional relationships. So, an accountant shall:

- Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member.
- Maintain confidentiality of information within the firm or employing organization.

- Maintain confidentiality of information disclosed by a prospective client or employing organization.
- Not disclose confidential information to outside sources without proper approval.
- Not use or disclose any confidential information, either acquired or received as a result of a professional or business relationship, after that relationship has ended.

However, since confidentiality serves the public interest there are few **exceptions to this principle**. An information can be disclosed:

- If Disclosure is required by law, for example:
  - Production of documents or other provision of evidence in the course of legal proceedings; or
  - Disclosure to the appropriate public authorities of infringements of the law that come to light;

- If disclosure is permitted by law and is authorized by the client or the employing organization.

- If there is a professional duty or right to disclose, when not prohibited by law:
  - To comply with the quality review of a professional body;
  - To respond to an inquiry or investigation by a professional or regulatory body;
  - To protect the professional interests of a professional accountant in legal proceedings; or
  - To comply with technical and professional standards, including ethics requirements.

Professional Behaviour

A professional accountant shall not knowingly engage in any business, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession. Conduct that might discredit the profession includes conduct that a reasonable and informed third party would be likely to conclude adversely affects the good reputation of the profession.

When undertaking **marketing or promotional activities**, a professional accountant shall not bring the profession into disrepute. A professional accountant shall be honest and truthful and shall not make:

  - Exaggerated claims for the services offered by, or the qualifications or experience of, the accountant; or
  - Disparaging references or unsubstantiated comparisons to the work of others.

2. Threats to the fundamental principles

The Code of Ethics for Professional Accountants identifies the following categories of threats to the fundamental principles ***(Section R120.6)***.

Threat	**Explanation**
Self-interest	A financial or other interest will inappropriately influence a professional accountant's judgment or behavior.
Self-review threat	A professional accountant **will not appropriately evaluate the results** of a previous judgment made, or an activity performed by the accountant or by another individual within the accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity.
Advocacy threat	A professional accountant will promote a client's or employing organization's position to the point that the accountant's objectivity is compromised.
Familiarity threat	The threat that due to a long or close relationship with a client, or employing organization, a professional accountant will be too sympathetic to their interests or too accepting of their work.
Intimidation threat	The threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

It is important to note that a circumstance **might create more than one threat**, and a threat **might affect** compliance with **more than one fundamental principle**.

Section 200.6 A1 describes and provides **examples for the threats** for fundamental principles for an **accountant in business (Page 38)**.

Threat	Example
Self-interest Threats	▪ A professional accountant holding a financial interest in, or receiving a loan or guarantee from, the employing organization. ▪ A professional accountant participating in incentive compensation arrangements offered by the employing organization. ▪ A professional accountant having access to corporate assets for personal use. ▪ A professional accountant having access to corporate assets for personal use.

Self-review Threats	A professional accountant determining the appropriate accounting treatment for a business combination after performing the feasibility study supporting the purchase decision.
Advocacy Threats	A professional accountant having the opportunity to manipulate information in a prospectus in order to obtain favorable financing.
Familiarity Threats	▪ A professional accountant being responsible for the financial reporting of the employing organization when an immediate or close family member employed by the organization makes decisions that affect the financial reporting of the organization. ▪ A professional accountant having a long association with individuals influencing business decisions.
Intimidation Threats	▪ A professional accountant or immediate or close family member facing the threat of dismissal or replacement over a disagreement about: ○ The application of an accounting principle. ○ The way in which financial information is to be reported. ▪ An individual attempting to influence the decision-making process of the professional accountant, for example with regard to the awarding of contracts or the application of an accounting principle.

In addition to above there are times when an accountant may have an incentive to misrepresent the performance or position of an entity affecting ethical principles as follows.

- **Profit related bonuses**: An accountant might be motivated to maximize profit in the current period in order to achieve their bonus. Alternatively, if the current period targets have been met, an accountant might be motivated to shift profits into the next reporting period.

- **Financing**: An entity is more likely to be given a loan if it has valuable assets on which the loan can be secured. An incentive may therefore exist for the accountants to over-state assets on the statement of financial position.

- **Achieving a listing**: A company that is being listed on the stock exchange will want to maximize the amount that it receives from investors. This creates an incentive for the accountants to over-state the assets and profits of a company before it lists.

Where the above threats exist, appropriate safeguards must be put in place to eliminate or reduce them to an acceptable level. Safeguards against breach of compliance with the Code of Ethics for Professional Accountants include:

- Safeguards created by the profession, legislation or regulation (eg corporate governance)
- Safeguards within the employer
- Educational training and experience requirements for entry into the profession, together with continuing professional development

Question 01

Jake is responsible for preparing the warranty provision as part of the yearend financial statements. Jake's manager, the financial controller, has reminded Jake that the warranty provision will impact on the profit related pay bonus that both he and Jake are entitled to receive. The financial controller then mentions his own holiday plans and that he needs the bonus to pay for it.

Required to **identify** and **explain** the ethical threats is Jake facing?

3. The benefits of ethics in financial reporting

Quality decision making and investor confidence both require complete and accurate financial record keeping and financial reporting. **Investor confidence** is increased if a company acts ethically in its financial reporting.

4. Dealing with ethical conflict

Below steps can be followed in resolving an ethical conflict.

1. Determine all the relevant facts of the situation.
    a. Without all the facts, appropriate judgement is impossible. For example, what are the company's policies and procedures that might be relevant?
2. Who are the relevant parties?
    a. Identify all affected stakeholders and prioritize the validity of their claims using a suitable, fair methodology.
3. What are the ethical issues involved? Are there ways in which ethical guidance pulls you in opposite directions in this scenario? What are the cultural norms involved, both nationally and within the company? Does the company have any specific guidance on this area?
4. What are the fundamental ethical principles involved (eg integrity, objectivity)? What are the apparent threats and are there any professional guidance statements that might be of use?
5. What are all the alternatives that might be helpful in this scenario?

6. Of the alternatives in step 5, which seem to provide the best fit with professional ethical guidance, your own ethical principles, the policies of the company and the legitimate claims of each stakeholder?
7. What is your conclusion? Give reasons for your conclusion.

Question 02

In the scenarios below, what are the threats to objectivity? How serious are they? What actions should the affected parties take to mitigate the risks to independence?

1. The CFO holds a large number of shares in the listed company that the CFO works for. Currently the CFO needs to authorise an appropriate figure for the company's allowance for receivables and has been provided with a range of four estimates by members of the finance team.
2. The in-house head of the tax planning team has been asked to advise the board on what figure should be incorporated in the financial statements for current tax payable.
3. The valuation of certain over-the-counter derivatives is performed by the financial controller using a spreadsheet that the financial controller has developed. It is notoriously complicated and the model used has never been updated by any other person.
4. The company's performance for the current year is looking to be rather embarrassingly below estimates that were given to investors when the company was floated on the Colombo Stock Exchange two years ago.
5. The board of directors of a large company consists entirely of non accountants. In practice, the board takes the recommendations of the CFO on all finance matters. The CFO has come to implicitly trust the advice of the chief accountant. The CFO will only ever sign any documents if the chief accountant initials a sticky note on each document with the words 'OK to sign'.
6. The company is being sued for trade defamation by a rival. It was recently notified of the legal claim by lawyers acting for the other side, though the dispute is in its early stages. The dispute arose from a joke the CEO made at a recent trade conference. The company says that it will contest the case, which the CEO describes as 'silly, attention seeking and just a publicity stunt'.