3 Professional relationships: The role of ethics and independence

The public accountant (PA) is a professional who works with the audit committee, board of directors, management, and other professionals such as lawyers. In addition to providing a high quality of work, the PA is expected to be free from bias and to behave in an ethical manner. In this chapter, we will look at some of the issues and rules affecting the professional accountant's behaviours in relationship with others.

Rules of professional conduct are regularly updated by all accounting professions, and qualified accountants are expected to abide by these rules whether they work in public accounting, in industry, in education, or in the not-for-profit sector. As a potential PA, it is important that you understand how these rules govern your relationships with your fellow members and potential clients. If you will be working as a management accountant, specialist, or internal or government auditor, you will still be bound by the rules of the professional accounting organizations you are a member of. Some of those rules are discussed in this chapter.

LEARNING OBJECTIVES

1 Describe ethics and their relevance. Acquire tools to promote ethical conflict resolution (also known as working through an ethical dilemma).

2 Explain how PAs are different from other professionals. Examine the role of a code of professional conduct in encouraging PA ethical behaviour. Apply rules of professional conduct to case facts and identify violations.

3 Examine the threats to independence and explain how the threats can be mitigated. Discuss how the auditor's relationship with the audit committee affects independence. Identify some of the key rules of professional conduct and how are they enforced.

STANDARDS REFERENCED IN THIS CHAPTER

CICA Standards

CAS 220 – Quality control for an audit of financial statements

Section 5030 – Quality control procedures for assurance engagements other than audits of financial statements and other historical financial information

Section 7600 – Reports on the application of accounting principles

CSQC-1 – Quality control for firms that perform audits and reviews of financial statements and other assurance engagements

The Value of the Audit Depends on Auditor Independence

Bruce Smith is a senior auditor who works on the audit of the Canadian subsidiary of Ultimate Networks, an audit client in his firm's Hong Kong office. Bruce has watched the shares of Ultimate Networks soar for the last six months. Ultimate Networks is gaining market share, and he knows that their sales will continue to soar with the new technology that they have in the pipeline. Finally, he can't resist any longer. He calls his investment broker, John Rizzo, and places an order for 200 shares of Ultimate Network's shares. "Are you sure this is okay?" asked Rizzo. "I thought Ultimate Networks was one of the jobs that you enjoyed working at." Rizzo knows about professional responsibilities because he worked with Bruce at a PA firm prior to becoming an investment broker, and they remained friends. "Why don't you check it out and get back to me?" Rizzo added.

IMPORTANCE TO AUDITORS

The next morning, Bruce is glad that he has John Rizzo for an investment broker. The recent CPAB reports talked about the importance of independence and that it had uncovered some independence violations at member firms. Firms even had to recall audit reports. The result could have included partners and audit staff being terminated for making share investments similar to the investment that Bruce contemplated the day before. Bruce remembers that he is required to annually sign a statement that he does not own shares in a long list of client firms. In the past he had treated them as a formality and not really read through the list before signing it. It would have been a grave mistake for him to purchase those shares.

As he thinks about the requirement that he not own shares in an audit client, he concludes, "There are plenty of other good investments out there."

WHAT DO YOU THINK?

1. Independence is one of the most important characteristics of the external auditor. Why would someone like Bruce consider ignoring it?
2. How can firms help people like Bruce understand the importance of independence?
3. Should employees who violate independence rules be terminated from their employment immediately?

1 Ethical Behaviour is a Cornerstone of Trust

What Are Ethics?

Ethics—a set of moral principles or values.

Ethics can be defined broadly as a set of moral principles or values. Each of us has such a set of values, although we may or may not have considered them explicitly. Philosophers, religious organizations, and other groups have defined, in various ways, ideal sets of moral principles or values. Examples of prescribed sets of moral principles or values at the implementation level include laws and regulations, church doctrines, codes of business ethics for professional groups such as CAs, CGAs, and CMAs, and codes of conduct within individual organizations such as accounting firms, corporations, and universities.

An example of ethical principles is included in Table 3-1 below. These principles were developed by combining principles from the Josephson Institute of Ethics (a non-profit organization focused on ethical quality) with ethical standards published by both an international coaching organization and a technical journal.

A search of the internet will reveal thousands of sites with published ethical standards, for example, the Canadian Standards Association (**www.csa.ca**).

It is common for people to differ in their moral principles or values and the relative importance they attach to these principles. These differences reflect life experiences, successes and failures, and the influences of parents, teachers, religious organizations, and friends.

NEED FOR ETHICS Ethical behaviour is necessary for a society to function in an orderly manner. It can be argued that ethics is the glue that holds a society together. Imagine, for example, what would happen if we could not depend on the people we deal with to be honest. If parents, teachers, employers, siblings, co-workers, and friends all consistently lied, it would be almost impossible for effective communication to occur.

The need for ethics in society is so important that many commonly held ethical values are incorporated into laws. However, many of the ethical values found in Table 3-1 cannot be incorporated into laws because of the judgmental nature of certain values.

Table 3-1 Illustrative Ethical Principles

The following list of ethical principles incorporates characteristics and values that many people and organizations associate with ethical behaviour.

Trustworthiness	Be honest and reliable. Honour your agreements or promises, and do not intentionally mislead others. Be reliable—do your best to fulfill your commitments. Declare conflicts of interest. Act promptly to disclose hazards.
Respect	Be civil, courteous, and accepting of others, understanding the many differences that exist among people. Be unbiased in your decision making.
Responsibility	Be accountable for your own actions and aware of the actions of those you are supervising. Keep confidential information confidential. Use resources wisely and economically. Do not use the work of others without declaring the source. Identify your own competence levels and act within that competence.
Fairness	Judge actions and individuals on their merits, considering the equality of individuals and having regard for due process and transparency.
Caring	Act out of a positive intention to do no harm or to minimize harm. Be concerned for others, showing benevolence when it is within your ability to do so.
Citizenship	Obey laws, and assist others in obeying laws, including the reporting of offenders. Help your society function by participating in voting, volunteer work, and the conservation of resources.

Sources: 1. ASME Technical Journals, **www.asme.org**, Accessed: November 29, 2011. 2. International Coach Federation, **www.coachfederation.org**, Accessed: November 29, 2011. 3. The Josephson Institute, **www.josephsoninstitute.org**, Accessed: November 29, 2011.

WHY PEOPLE ACT UNETHICALLY Most people define unethical behaviour as conduct that differs from what they believe would have been appropriate given the circumstances. Each of us decides what constitutes ethical behaviour. It is important to understand what causes people to act in a manner that we decide is unethical.

There are two primary reasons why people act unethically: the person's ethical standards are different from those of society as a whole, or the person chooses to act selfishly. Both reasons may exist.

The person's ethical standards differ from general society's Extreme examples of people whose behaviour violates almost everyone's ethical standards are drug dealers, bank robbers, and larcenists.

Many far less extreme examples exist where others violate our ethical values. When people cheat on their tax returns, treat other people with hostility, lie on employment applications, or perform below their competence levels as employees, most of us regard that as unethical behaviour. If the other person has decided that this behaviour is ethical and acceptable, there is a conflict of ethical values.

The person chooses to act selfishly The difference between ethical standards that differ from general society's and acting selfishly is illustrated in the following example: Aaron finds a briefcase in an airport containing important papers and $1,000. He tosses the briefcase and keeps the money. He brags to his family and friends about his good fortune. Aaron's values probably differ from most of society's. Brenda faces the same situation but responds differently. She keeps the money but leaves the briefcase in a conspicuous place. She tells nobody and spends the money on a new wardrobe. It is likely that Brenda has violated her own ethical standards, but she has decided that the money was too important to pass up. She has chosen to act selfishly. What would you do? Shouldn't the briefcase and its entire contents be returned? Consider Carl who returns the entire briefcase and gets a reward of $500.

This example shows that unethical behaviour often results from selfish motives. Political scandals result from the desire for political power. Cheating on tax returns and expense reports is motivated by financial greed. Performing below one's competence and cheating on tests are due to laziness or perceived lack of time. In each case, the person knows that the behaviour is inappropriate but chooses to do it anyway because of the apparent personal sacrifice needed to act ethically.

Ethical dilemma—a situation in which a decision must be made about the appropriate behaviour.

An **ethical dilemma** is a situation a person faces in which a decision must be made about appropriate behaviour. A simple example of an ethical dilemma was finding a briefcase, which involves deciding whether to try to find the owner or to keep it. Far more difficult ethical dilemmas can arise in the auditing profession. Consider Qin Zhang. Qin is the senior auditor in-charge of the September 30, 2011, financial statement audit of Paquette Forest Products Inc., a forest products company that produces lumber and paper products in northern Manitoba. The company employs 375 people and is the main employer in the remote town of Duck Lake, Manitoba; the other businesses in Duck Lake provide goods and services to Paquette Forest Products and its employees. In the course of the audit, Qin discovers that the company has had a number of failures of the equipment that removes the sulphuric acid from the paper production process and, as a result, thousands of litres of untreated water have been dumped into the Loon River and Duck Lake. Qin learns that the cost of replacing the equipment so that no further spills are likely would strain cash reserves. If ordered to replace the equipment by the environment ministry, the company would be forced to raise additional capital or cease operations. What should Qin do?

Auditors, accountants, and other business people face many ethical dilemmas in their business careers. Dealing with a client who threatens to seek a new auditor unless an unqualified opinion is issued presents a serious ethical dilemma if an unqualified opinion is inappropriate. Deciding whether to confront a supervisor who has materially overstated departmental revenues as a means of receiving a larger bonus is tough to do. Continuing to be a part of the management of a company that harasses and mistreats employees or treats customers dishonestly is an ethical dilemma, especially if the manager has a family to support and the job market is tight. Deciding whether or not to report the negligence of a supervisor to a partner is a problem you may face as a staff accountant.

RATIONALIZING UNETHICAL BEHAVIOUR There are alternative ways to resolve ethical dilemmas, but care must be taken to avoid methods that are rationalizations of unethical behaviour. The following are commonly employed rationalization methods that can easily result in unethical conduct:

1. *Everybody does it.* The argument that it is acceptable to falsify tax returns, cheat on exams, or sell defective products ("just obeying orders") is commonly based on the rationalization that everyone else is doing it and therefore it is acceptable.
2. *If it's legal, it's ethical.* Using the argument that all legal behaviour is ethical relies heavily on the perfection of laws. Under this philosophy, one would have no obligation to return a lost object to its owner unless the other person could prove that it was his or hers.
3. *Likelihood of discovery and consequences.* This approach relies on evaluating the likelihood that someone else will discover the behaviour. Typically, the person also assesses the severity of the penalty (consequences) if there is a discovery. An example is deciding whether to correct an unintentional overbilling to a customer when the customer has already paid the full billing. If the seller believes the customer will detect the error and respond by not buying in the future, the seller will inform the customer now; otherwise the seller will wait to see if the customer complains.

RESOLVING ETHICAL DILEMMAS In recent years, formal frameworks have been developed to help people resolve ethical dilemmas. The purpose of such frameworks is to help a person identify the ethical issues and decide on an appropriate course of action based on the person's own values. This six-step approach is intended to be a relatively simple approach to resolving ethical dilemmas:

1. Obtain the relevant facts.
2. Identify the ethical issues from the facts.
3. Determine who is affected by the outcome of the dilemma and how each person or group is affected.
4. Identify the alternatives available to the person who must resolve the dilemma.
5. Identify the likely consequence of each alternative.
6. Decide on the appropriate action.

A more recent approach, titled *Giving Voice to Values*[1] (GVV), provides a framework for dealing with ethical issues in a proactive way, with the assumption that the organization is willing to work to resolve ethical dilemmas and the person at the centre of the dilemma is willing to take action. The steps in the GVV Process[2] are:

1. *Identification:* Identifying the ethical issue, the values underpinning the different positions in this value conflict and the possibilities for action.
2. *Purpose and choice:* Considering your personal and professional purpose and choices.
3. *Stakeholder analysis:* Who is affected, what is at stake for them, and how do you connect with them?
4. *Powerful response:* Craft a useful, powerful response that you could use, taking into account multiple options, the need for additional information, working with allies, and who your audience would be.
5. *Scripting and coaching:* Further develop and practise your response (scripting) and get help (coaching).

We now use the GVV approach to consider an unfortunately common ethical dilemma that you might encounter in your future career.

[1] Gentile, M. C. & Hittner, J. 2010. *Giving Voice to Values: How to Speak Your Mind When You Know What's Right.* Yale University Press, New Haven.

[2] Chappell, S., M. Edwards and D. Webb. (2011) *Giving Voice to Values: A means of shifting the teaching and practices of business ethics*, 18th Annual International Vincentian Conference Promoting Business Ethics, St, John's University, New York, October 26–28, 2011.

Shifting Values Using the GVV Five-Step Approach

ETHICAL DILEMMA Bryan Longview has been working for six months as a staff assistant for De Souza & Shah, public accountants. Currently he is assigned to the audit of Reyon Manufacturing Corp. under the supervision of Karen Van Staveren, an experienced audit senior. There are three auditors assigned to the audit, including Karen, Bryan, and a more experienced assistant, Martha Mills. During lunch on the first day, Karen says, "It will be necessary for us to work a few extra hours on our own time to make sure we come in on budget. This audit isn't very profitable anyway, and we don't want to hurt our firm by going over budget. We can accomplish this easily by coming in a half hour early, taking a short lunch break, and working an hour or so after normal quitting time. We just won't write that time down on our time report." Bryan recalls reading in the firm's policy manual that working extra hours and not charging for them on the time report is a violation of De Souza & Shah's employment policy. He also knows that seniors are paid bonuses instead of overtime, whereas staff are paid for overtime but get no bonuses. Later, when Bryan discusses the issue with Martha, she says, "Karen does this on all of her jobs. She is likely to be our firm's next audit manager. The partners think she's great because her jobs always come in under budget. She rewards us by giving us good engagement evaluations, especially under the cooperative attitude category. Several of the other audit seniors follow the same practice."

1. *Identification:* Bryan recognizes that Karen's request violates firm policies and is underpinned by a desire to meet the expected budget and the value she places on career advancement. Bryan also knows that these practices affect the firm's quality control, since budgeting and time management will not be accurate. By violating one firm policy, he and his other team members could be on the slippery slope to violating other practices, such as signing off incomplete work.
2. *Purpose and choice:* Bryan takes the time to reconnect with his broader purpose of being an accountant: to contribute to the accurate reporting and financial survival of the organizations he serves. As such, he recognizes that it is partly his responsibility to change this practice of not recording overtime. He would like to be in compliance with his firm's practices and record his time honestly. Prior to acting, he needs to gather more information and think about the best way to move forward.
3. *Stakeholder analysis:* Bryan documents who the affected stakeholders are, as well as how they are affected both if he does give voice and does not give voice. Some of his analysis is shown in Table 3-2. To help him with crafting his response, he

Table 3-2 Extract from Bryan's Stakeholder Analysis

Stakeholder	What's at stake if I DO give voice?	What's at stake if I DO NOT give voice?
Karen and other supervisors doing the same	• They have the option of changing their practices. • They could be demoted or otherwise affected. • They could receive a lower performance bonus.	• They are encouraged to employ these practices with other clients. • They receive a larger performance bonus. • They could be pressured into poor quality work that enables client management to receive higher performance bonuses.
Me and my other team members	• We are able to record our hours honestly. • We receive a higher wage (overtime). • We are motivated to produce high-quality work since the time and effort spent is recognized and rewarded.	• We will be under pressure to do the same at other clients. • We receive a lower wage. • We will be encouraged to follow the same practice when we become supervisors. • We are motivated to leave the firm and go to an employer where this practice does not exist.
De Souza and Shah firm	• Quality control standards are followed. • Jobs are properly billed and budgeted. • Employee training can focus on encouraging good job practices and discouraging poor recording.	• May result in underbilling clients in current and future engagements. • May be unable to realistically budget other engagements. • May affect the firm's ability to motivate and retain employees. • Firm could be sued for not following labour laws with respect to payment of overtime.

Table 3-3 Extract of Bryan's Inhibiting Arguments, Enabling Arguments and Levers Relevant to Accurate Recording of Hours Worked

Inhibiting Arguments	Enabling Arguments	Levers
Obedience to supervisor: It's not my responsibility; I'll get in trouble.	As an employee, it is everyone's job to ensure quality control.	Supervisors who change their practices to follow firm standards may be rewarded.
Standard practice: Everyone is doing this so it's standard practice.	Some supervisors are not doing this, and they are getting rewarded for good quality work.	A different supervisor on this engagement next year could detect the problem and cause problems for Karen.
Lack of materiality: It's just a few hours. It won't make any difference.	These hours add up over many engagements, and this affects our employer's profitability.	If the underbilling is detected, it could cause peer review problems with our employer.
Us versus them: I'll be targeted as a trouble maker by all of the supervisors.	Supervisors who record their work honestly will support me, as will the standards partner of our firm.	Karen and other supervisors will be supported by the standards partner for recording time accurately.

thinks about and develops a list of inhibiting arguments, enabling arguments, and levers he can use to support his case. He lists the top four arguments in Table 3-3.

4. *Powerful response*: Having identified the stakeholders involved and the arguments he may encounter, Bryan thinks about the logistics of how to move forward. Who should he speak with first? What data will he need to bring to each conversation? Bryan decides the first step is to talk to his university classmates. He finds out that one other person has been subjected to this same pressure at one of his clients, but that all of his other classmates have received peer mentor counselling at their firms. Apparently the firms know that this practice exists and want to stamp it out because it reduces the ability of junior employees to express themselves during engagements. He puts together a list of the firms with such programs and a summary of the benefits for such programs and the costs of not addressing these practices.

   Bryan also talks confidentially to his provincial institute's peer support program and gains some valuable information and a sense of support for his intended strategy to raise this issue with Karen first.

5. *Scripting and coaching:* Armed with this information, Bryan writes out an opening statement that clearly frames the conversation as an opportunity for learning and moving towards best practice. He also assumes Karen will respond with each and every inhibiting argument and writes out his intended response. He practises in front of the mirror the things he would say to Karen. In his practice, he considers both a positive response and a negative response. He then makes an appointment with Karen, so that he can talk to her before the weekly time sheets are due.

The results? Only Bryan can tell us, but he is more likely to have a successful conversation with Karen that is businesslike and constructive.

2 Professional Ethics and Principles of Conduct

Special Need for Ethical Conduct in Professions

Our society has attached a special meaning to the term "professional." A professional is expected to conduct himself or herself at a higher level than many other members of society. For example, when the press reports that a physician, clergyperson, member of Parliament, CA, CGA, or CMA has been indicted for a crime, most people feel more disappointment than when the same thing happens with people who are not labelled as professionals.

auditing in action 3 - 1

Some Ethical Violations Are More Severe Than Others

Bryan Longview's ethical dilemma involves a situation in which he is asked to work without regarding the time, which is sometimes called kitchen-tabling or eating time. One of the concerns with eating time is that it can lead to a more severe problem known as premature signoff, in which a staff person signs off as having completed work without performing the necessary procedures.

Tom Holton has far too busy a social life to work overtime. To make certain that work does not interfere with his other plans, he tests only part of the assigned sample. For example, if he is asked to test 25 cash disbursement transactions, he tests the first 15 but indicates that he has tested all 25. A supervisor, curious about Tom's amazing ability to beat the time budget, decides to carefully reperform Tom's work. When the firm discovers that Tom is signing off procedures without completing them, he is dismissed that day—no counselling out, no two weeks' notice.

The term "professional" carries a responsibility for conduct that extends beyond satisfying the person's responsibilities to himself or herself and beyond the requirements of our society's laws and regulations. This responsibility is to the public, to the client, and to fellow practitioners and includes honourable behaviour even if that means personal sacrifice. A CA, CGA, or CMA in public practice is a professional who carries that responsibility.

The underlying reason for a high level of professional conduct by any profession is the need for public confidence in the quality of service by the profession, regardless of the individual providing it. For the professional PA, it is essential that the client and external financial statement users have confidence in the quality of audits and other services. If users of services do not have confidence in physicians, judges, or PAs, the ability of those professionals to serve clients and the public effectively is diminished.

It is not practical for users to evaluate the performance of professional services because of their complexity. A patient cannot be expected to evaluate whether an operation was properly performed. A financial statement user cannot be expected to evaluate audit performance. Most users have neither the competence nor the time for such an evaluation. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and conduct on the part of all practitioners.

Increased competition sometimes makes public accounting firms concerned about keeping clients and maintaining a reasonable profit. Because of the increased competition, many public accounting firms have implemented philosophies and practices that are frequently referred to as "improved business practices." These include such things as improved recruiting and personnel practices, better audit quality control practices, effective office management, and tailored advertising and other promotional methods. Public accounting firms are also attempting to become more efficient in doing audits in a variety of ways, for example, through the use of computers, effective audit planning, and careful assignment of staff.

Standards for obtaining, renewing, and retaining PA licences or rights in many provinces (such as a minimum number of annual hours in provision of assurance services) mean that detailed engagement record keeping is crucial. For those accounting students who do not want to work in public practice, other types of work experience in industry are now possible.

concept check

C3-1 What are the six ethical principles that many people and organizations associate with ethical behaviour?

C3-2 Describe an ethical dilemma. What are two approaches for resolving an ethical dilemma?

DIFFERENCE BETWEEN PUBLIC ACCOUNTING FIRMS AND OTHER PROFESSIONALS Public accounting firms have a different relationship with users of financial statements than most other professionals have with the users of their services. Lawyers, for example, are typically engaged and paid by a client and have the primary responsibility to be an advocate for that client. Public accounting firms are engaged by management for private companies and by the audit committee for public companies. The firms are paid by the company issuing the financial statements, but the primary beneficiaries of the audit are financial statement users. Often, the auditor does not know or have contact with those users but has frequent meetings and ongoing relationships with client personnel.

It is essential that users regard such public accounting firms as competent and unbiased. If users were to believe that such public accounting firms do not perform the valuable service of reducing information risk, the value of and demand for those firms' audit and other attestation reports would be reduced. This provides incentives for public accounting firms to conduct themselves at a high professional level.

Ways Professional Accountants in Public Practice Are Encouraged to Conduct Themselves Professionally

There are several ways in which society and the public accounting professions encourage those in public practice to conduct themselves appropriately and to do high-quality audits and related services. Figure 3-1 shows the most important ways. Several of these were discussed in Chapter 2, including GAAS requirements, the Recommendations of the *CICA Handbook*, professional examinations, quality control, the CPAB and provincial securities commissions, practice inspection, and continuing education. The ability of individuals to sue public accounting firms also exerts considerable influence on the way practitioners conduct themselves and audits. Legal liability is studied in Chapter 4.

The code of professional conduct of the PA's respective accounting body also has a significant influence on the practitioner. It is meant to provide a standard of conduct for members of that body. When professionals do not adhere to the standards of their profession, they are subject to a variety of potential sanctions. Table 3-4 explains that many of these are related to public release of information about the actions of the accountant, which is why the table is called "For Whom the Bell Tolls."

Code of Professional Conduct

A code of conduct can consist of general statements of ideal conduct or specific rules that define unacceptable behaviour. The advantage of general statements is

Figure 3-1 Ways the Profession and Society Encourage Public Accountants to Conduct Themselves at a High Level

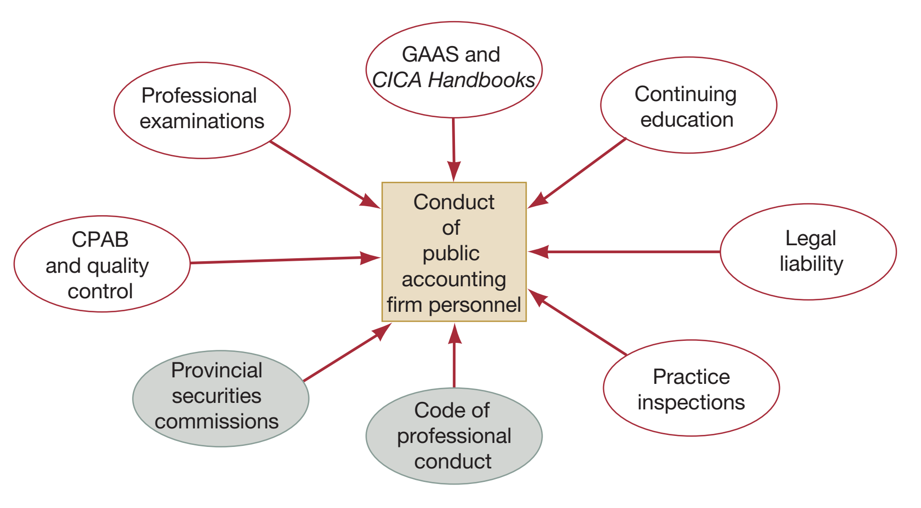


Table 3-4	For Whom the Bell Tolls

Examples of Sanctions That Can Be Imposed Against PAs or Firms When Standards Are Violated
Publication of the name(s) of the violator(s) and the nature of the convicted offence
Sanctions from regulatory bodies such as the CPAB, OSC, or the SEC (e.g., refusal to accept new publicly listed clients for a period of time)
Refusal to renew PA licences for individuals or firms (with the CPAB)
Increased frequency of peer review
Appointment of an external monitor
Fines and/or payment of costs such as legal fees
Requirements to change quality control procedures
Mandatory education
Suspension of designation (e.g., CA, CGA, or CMA) or expulsion from the professional association

the emphasis on positive activities that encourage a high level of performance. The disadvantage is the difficulty of enforcing general ideals because there are no minimum standards of behaviour. The advantage of carefully defined specific rules is the enforceability of minimum behaviour and performance standards. The disadvantage is the tendency of some practitioners to define the rules as maximum rather than minimum standards. A second disadvantage is that some practitioners may view the code as the law and conclude that if some action is not prohibited, it must be ethical. A practitioner must consider the intent of the code in addressing whether a particular action is acceptable or not.

A professional code of conduct serves both the members of the body promulgating the code and the public. It serves members by setting standards the members must meet and providing a benchmark against which the members will be measured by their peers. The public is served because the code provides a list of standards that the members of the body should follow and helps determine expectations of members' behaviours. Yet such a code will be followed only in an organization with the appropriate organizational culture, as explained in Auditing in Action 3-2.

At present, most PAs in Canada are either CAs or CGAs. The provincial institutes and Quebec *ordre* of chartered accountants determine the rules of professional conduct for members and students of that provincial institute or *ordre*. The provincial institutes and *ordre* have harmonized their rules of professional conduct so that, generally, the same set of rules applies to all PAs in Canada. Certain rules (e.g., confidentiality, which is discussed below) apply to students as well as to members. All of the rules apply to members in public practice, while a smaller number also apply to members who are not engaged in the practice of public accounting.

We will restrict the remainder of our discussion to rules of conduct of British Columbia CGAs and Ontario CAs (as examples of provincial rules of conduct).

Generally the codes of conduct have attempted to accomplish both the objectives of general statements of ideal conduct and of specific rules. For example, the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario (ICAO) have principles that are stated in broad terms, the rules themselves, and additional guidance on the rules, called "interpretations." The ICAO, the Certified General Accountants Association of British Columbia (CGA-BC), and other organizations such as the Institute of Internal Auditors (IIA), provide discussions of current issues and examples of how to deal with particular ethical issues through regular newsletters sent to members. Figure 3-2 is illustrative of this. The structure is listed in order of increasing specificity: The principles provide ideal standards of conduct, whereas rules of conduct are more specific, and the interpretations or examples are very specific.

auditing in action 3-2

Research on Commitment Helps Explain Violations

Can you do the audit of an organization that you are marketing with? As explained in the next section, this could be a self-interest threat, because your own financial results are linked with those of the organization. One of the top international accounting firms was barred from accepting new SEC clients for six months as it both audited PeopleSoft Inc. as well as marketed and installed the software. The firm maintained that it was not violating the rules, yet this clearly violated the appearance of objectivity of the firm.

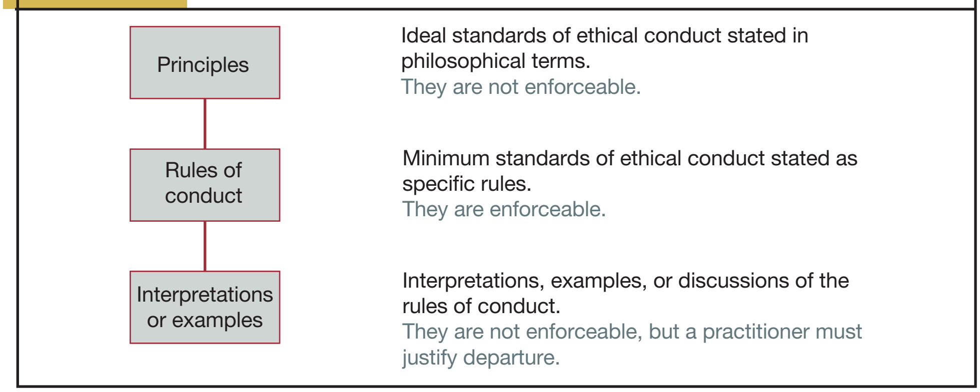
Tyler, Dienhart, and Thomas talked about the "command and control" versus the "values and integrity" approach to ethical compliance. In a values and integrity model, employees are encouraged to comply with ethical processes because they understand the goals of the processes, and they believe that they are fair. This encourages employees to come forward with what they believe are ethical violations. In the command and control model, as advocated by strict rules, employees are less likely to comply with rules and may not come forward with potential violations.

The most important finding discussed in Tyler et al.'s article was the fact that organizational culture is the most important variable in ethical compliance—more important than the type of ethical compliance program. This means that organizations that are focused on profits to the exclusion of anything else send the message to employees that ethics do not matter. Perhaps something like this happened at the accounting firm involved—the profits from software sales and installation were considered more important than independence.

Sources: 1. Morris, Floyd, "Big auditing firm gets 6-month ban on new business," *The New York Times*, April 17, 2004, **www.nytimes.com/2004/04/17/business/17ERNS.html**, Accessed: September 14, 2008. 2. Tyler, Tom, John Dienhart, and Terry Thomas, "The ethical commitment to compliance: Building value-based cultures," *California Management Review*, 50(2), Winter 2008, p. 21–51.

PRINCIPLES OF PROFESSIONAL CONDUCT The principles generally are characteristics that the professional body deems desirable in its members. An organization is judged by the behaviour of its members; therefore, one principle would be that members behave in a way that enhances the reputation of all the members. Members should act ethically and in a way that will serve the public interest. For example, CGA-BC at **www.cga-bc.org** talks about "safeguarding and advancing the interests of society," while the ICAO at **www.icao.on.ca** talks about "conduct[ing engagements] . . . in a manner which . . . serve[s] the public interest." Both CGAs and CAs are also told that they should not use confidential information for their own benefit and to avoid (and where unavoidable to disclose) conflicts of interest. When the courts discipline or

Figure 3-2 Structure of Code of Professional Conduct



convict a member of a profession, the profession's reputation suffers along with that of the member. It is a mistake to think that only the member loses his or her reputation in such a situation.

Other common principles are that members act with integrity and due care in the performance of their professional activities; that they maintain (i.e., keep current) their professional competence; that they do not undertake work for which they lack the necessary competence; and that they behave in a professional way toward colleagues. The accountant must maintain confidentiality with respect to the affairs and business of the client. There is one principle that relates more specifically to PAs: The accountant should ensure that he or she maintains an independent or objective state of mind when providing assurance services (e.g., audits or reviews) for clients.

A careful examination of these ethical principles will indicate that most are applicable to any professional, not just professional accountants. For example, physicians should behave in a way that is not discreditable to their profession; they should act ethically and in a way that serves the public interest; and they should exercise integrity and due care. Physicians should maintain their professional competence and behave in a professional way toward their colleagues. They should not breach their clients' confidentiality. These principles will be explored more fully in the remainder of this chapter.

EXAMPLES OF RULES OF CONDUCT The discussion that follows will consider some of the more important rules of conduct followed by PAs in Canada. A student interested in obtaining a particular professional designation (e.g., CA, CGA, or CMA) should refer to and become familiar with the specific rules of conduct of the provincial and national body to which he or she seeks admission.

While all the rules discussed below apply to members of the professional accounting bodies in public practice, some of the rules discussed do not apply to members who are not engaged in the practice of public accounting.

Figure 3-2 indicated that while principles may not be enforceable, the rules of conduct are. For that reason, the rules of conduct of the accounting bodies are stated in more precise language than the principles can be. Because of their enforceability, the rules are often called Rules or Code of Professional Conduct.

APPLICABILITY OF THE RULES OF CONDUCT The rules of conduct for CAs and CGAs specifically state that while the rules are for all CAs and CGAs, respectively, certain rules, because of their nature, may apply only to members who are in public practice.

It would be a violation of the rules if someone did something on behalf of a member that would have been a violation if the member had done it. An example is a banker who states in a newsletter that Johnson and Able, public accountants, have the best tax department in the province and consistently get large refunds for their tax clients. This is likely to create false or unjustified expectations and is a violation of both the CA and CGA rules of conduct.

A member is also responsible for compliance with the rules by employees and partners.

DEFINITIONS A few definitions must be understood to minimize misinterpretation of the rules to be discussed shortly.

- Client—the person(s) or entity that retains a member or his or her firm, engaged in the practice of public accounting, for the performance of professional services.
- Firm—a proprietorship or partnership engaged in the practice of public accounting, including individual partners thereof.
- Member—a member of the Canadian Institute of Chartered Accountants (and a provincial institute or *ordre*) or of the Certified General Accountants Association of Canada (and a provincial association) or of the Society of Management Accountants of Canada (and a provincial association).
- Practice of public accounting—representing oneself as a PA and at the same time performing for a client one or more types of services rendered by PAs.

concept check

C3-3 Explain the need for a code of professional ethics for PAs. In which ways should the PAs' code of ethics be similar to and different from those of other professional groups such as lawyers or dentists?

C3-4 List the three parts that may be part of the structure of a code of professional conduct, and state the purpose of each.

C3-5 What is meant by the statement, "The rules of professional conduct of a professional accounting organization should be regarded as a minimum standard?"

3

Professional Rules of Conduct for the Public Accountant

Independence

Independence—impartiality in performing professional services.

Generally, the rules of conduct promulgated by the accounting bodies require their members who are engaged in the practice of public accounting to be independent when they perform certain functions. For example, the rules require that auditors of historical financial statements be independent. **Independence** (impartiality in performing professional services) is also required for other types of attestation engagements such as review engagements.

Independence in auditing means taking an unbiased viewpoint in the performance of audit tests, the evaluation of the results, and the issuance of the auditor's report. If the auditor is an advocate for the client, a particular banker, or anyone else, he or she cannot be considered independent. Independence must be regarded as the auditor's most critical characteristic. The reason that many diverse users are willing to rely upon the professional PA's reports as to the fairness of financial statements is their expectation of an unbiased viewpoint.

Independence in fact—the auditor's ability to take an unbiased viewpoint in the performance of professional services.

Independence in appearance—the auditor's ability to maintain an unbiased viewpoint in the eyes of others.

PAs must maintain an independent attitude in fulfilling their responsibilities, and it is also important that the users of financial statements have confidence in that independence. These two objectives are frequently identified as "independence in fact" and "independence in appearance." **Independence in fact** exists when the auditor is actually able to maintain an unbiased attitude throughout the audit, whereas **independence in appearance** is the result of others' interpretation of this independence. If auditors are independent in fact but users believe them to be advocates for the client, most of the benefit of the audit function will be lost.

The Threats to Independence

In response to financial statement and management frauds, the professional accountant codes of conduct have adopted very specific rules of conduct with respect to independence. These rules are considered a foundation for providing public trust, since objectivity in an engagement relies upon auditor independence.

When deciding to accept a client or to continue an existing engagement, the PA is required to examine five threats to independence: self-interest threat, self-review threat, advocacy threat, familiarity threat, and intimidation threat. The PA is to assess threats when they exist and document the safeguards that were used to reduce the threats to an acceptable level. Table 3-5 lists and defines these threats to independence with examples. Table 3-6 describes safeguards that the firm can implement to either eliminate the threats or reduce them to an acceptable level.

Self-interest threat—a threat to independence where the member has a financial interest in the client or in the financial results of the client.

Advocacy threat—a threat to independence where the firm or member is perceived to promote (or actually does promote) the client's position.

Self-review threat—a threat to independence where the PA is in the position of having to audit his or her own work during the period.

Some of the threats affect overall independence. If you own shares in your client's business (**self-interest threat**) or are trying to help them obtain financing (**advocacy threat**), you stand to gain from the result of the financial statement audit.

The **self-review threat** means that you are auditing your own work. Imagine that you have assisted the client in designing an information system that calculates the costs for an inventory system. The new system seems to be working well, and there are excellent reports that track inventory movement and out-of-stock situations. However, during the design phase, you neglected to put in controls to highlight when the system creates a negative inventory situation, either due to either clerical or programming error.

What would you do during the audit? Perhaps you would be less likely to point out this error to the client in a management letter because it would imply that you did not properly perform your work during the system design. Alternatively, you might not detect the system inadequacy during your analysis of internal controls; you believe that it is such an excellent system that you do not need to complete a detailed analysis of internal controls. This example shows how a self-review threat can be very dangerous to the completion of a quality audit engagement.

Table 3-5 Threats to Independence

Threat to Independence (defined)	Examples
Self-interest threat—when the member could receive a benefit because of a financial interest in the client or in the financial results of the client or due to a conflict of interest.	The firm or member owns shares in or has made a loan to the client. The client fees are significant in relation to the total fee base of the PA or of the firm.
Self-review threat—when the PA is placed in the position of having to audit his or her own work or systems during the audit.	The reasons for this could be that the PA prepared original data or records for the client as part of a bookkeeping engagement or was an employee or officer of the organization. The PA could also have designed and implemented an accounting information system used to process client records.
Advocacy threat—when the firm or member is perceived to promote (or actually does promote) the client's position; that is, the client's judgment is perceived to direct the actions of the PA.	The PA is acting as an advocate in resolving a dispute with a major creditor of the client. The firm or PA is promoting the sale of shares or other securities for the client or is receiving a commission for such sales.
Familiarity threat—occurs when it is difficult to behave with professional skepticism during the engagement due to a belief that one knows the client well.	There is a long association between senior staff and the client (e.g., being on the engagement for 10 years). A former partner of the firm is now the chief financial officer of the client.
Intimidation threat—the client personnel intimidate the firm or its staff with respect to the content of the financial statements or with respect to the conduct of the audit, preventing objective completion of field work.	The client threatens to replace the audit firm over a disclosure disagreement. The client places a maximum upon the audit fee that is unrealistic with respect to the amount of work that needs to be completed.

With a **familiarity threat**, it may be that you were the audit junior on a job, worked as an assistant, then were promoted to supervisor and manager, and are now a partner. You have worked with the client for 15 years, and it seems that you know the strengths and weaknesses of all of the employees, juniors and executives alike. You may take it for granted that they are doing their jobs just as well this year as they did last year. However, you do not know that the controller is going through a messy divorce and the vice-president of finance has started gambling. They are both short of money, which gives them an incentive to manipulate the records and steal money from the company. The actual financial manipulation could lead to **intimidation threat**—where the senior accounting personnel expect you to overlook their manipulation or you may lose the audit. You have known these individuals for 15 years and think of them as friends, so what is a little financial statement manipulation among friends?

Familiarity threat—a threat to independence that occurs when it is difficult to behave with professional skepticism during the engagement.

Intimidation threat—a threat to independence that occurs when the client intimidates the public accounting firm or its staff with respect to the content of the financial statements or with respect to the conduct of the audit.

The independence rule situations listed in Table 3-7 help prevent independence threats from occurring. Some rules apply to all assurance engagements (e.g., financial

Table 3-6 Safeguards to Independence

Safeguard Category	Examples
Created by the profession or provided in legislation or securities exchange regulation	Education and training provided by the professional accounting body. Practice review provided by the professional accounting body or by the CPAB.
Provided by the client	A qualified, independent audit committee. A corporate code of ethics that provides for disclosure and resolution of conflicts. Competent client personnel.
Available within the firm's systems and procedures	Firm policies and procedures that promote awareness and ensure compliance for independence. Rotation of senior personnel on client engagements.

Table 3-7 Applicability of Independence Rule

Independence Rule Situation	Audit of Listed Entity	Audit of Non-listed Entity	Other Assurance Engagement (e.g., review)	Non-assurance Service
	Prohibited Engagements if Situation Applies During Term of Engagement			
Has direct or indirect financial interest	X	X	X	X
Exerts control over the entity	X	X	X	
Has a loan from or has a loan guaranteed by the entity (except in normal course of business; e.g., a bank)		X	X	
Has close business relationship	X	X	X	
Engagement staff accepted financial-related position at client within the last year	X			
Member of firm is officer or director	X	X	X	
Management decisions were made	X	X	X	
Prepared or changed originating source data or journal entry without management approval	X	X	X	
Accounting or bookkeeping services provided	X			
Valuation services provided	X			
Actuarial services provided	X			
Internal audit services provided	X			
Financial information systems design or implementation provided	X			
Expert opinion or service provided	X			
Legal services provided	X	X	X	
Human resources for senior positions provided	X			
Corporate finance services provided	X	X	X	

Note: Not all situations are listed. Please consult the rules of conduct for your provincial professional accounting association for more details.

Listed entity—an entity whose debts or shares are listed on a stock exchange and that has market capitalization and total assets greater than $10 million.

statement audit and review for businesses of all sizes), while others apply only to an entity listed on a stock exchange with total market capitalization greater than $10 million, called a **listed entity**.

In addition to the specifics described in Table 3-7, where the member or firm is not allowed to complete the engagement, there are situations where only the person affected is to be excluded from the engagement team. These are situations where the student or member:

- Has made a loan to or guarantees a loan to the client.
- Has an immediate family member as a director, officer, or employee who can exert control over the engagement or who is in an accounting role.
- Was an employee with the client in a financial oversight position during the duration of the audit.

At the engagement level, independence rules for listed clients include the mandatory rotation of senior personnel (with reinstatement provisions after two years) as follows: the engagement partner and quality control partner after five years (seven years in some provinces); other partners who provide more than 10 hours of service after seven years. All services to a listed client must be approved by the audit committee.

auditing in action 3 - 3

IESBA Code of Ethics for Professional Conduct

The International Ethics Standard Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* is also a principles-based framework consisting of three parts. Part A establishes five fundamental principles related to integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour. Part A also provides a conceptual framework that accountants can apply to identify threats to compliance with the fundamental principles, evaluate the significance of identified threats, and apply safeguards, when necessary, to eliminate the threat or reduce the threat to an acceptable level. Parts B and C of the IESBA Code describe how the conceptual framework applies in certain situations, including examples of safeguards and descriptions of situations where safeguards are not available to address threats. Part B applies to professional accountants in public practice while Part C applies to professional accountants in industry.

Source: International Ethics Standards Board for Accountants, Code of Ethics for Professional Accountants, **www.ifac.org**, Accessed: November 29, 2011.

A practical way for a PA to document the independence rules for each engagement is to fill in a checklist. A checklist actively states that the rules have been followed for the engagement and clearly identifies action taken where threats exist, with a conclusion stated for each engagement. This helps ensure that the assessment of independence is part of the quality assurance process for each engagement.

It seems from Table 3-7 that it would be difficult for a PA to provide comprehensive services to a client! What if you work for a small practice where the bulk of the work is accounting, bookkeeping, and review engagements? How is your work affected? Assuming that you and the other members of the firm have adequately addressed the five threats to independence, the primary practical concerns would be familiarity and self-review. There should be periodic change of staff at a client, where possible, and all transactions and journal entries should be discussed with and approved by the client before being processed.

Independence is far broader than simply preventing a financial interest, such as owning shares in a client. For the PA to be truly independent, all five threats must be considered and addressed for each engagement.

INDEPENDENCE THREAT ANALYSIS Public accounting firms are required to actively assess their ability to conduct an engagement prior to accepting (or renewing) the engagement. This means having policies and procedures in place to identify any new threats to independence, training employees, and monitoring the policies and procedures. If the current processes are not working (for example, employees may be investing in an organization unaware that it is a client of the firm), then new practices may be needed, such as having employees annually sign a form which lists every client, stating that they do not have any investments in those organizations. These new practices are an example of remedial action. Then, prior to accepting each engagement, audit management (such as the partner and the manager) is required to evaluate, in writing, the independence of the firm and the staff assigned to the engagement. This formal **independence threat analysis** forms part of the documentation for the engagement.

Independence threat analysis—assessment of independence threats for a particular engagement.

AUDIT COMMITTEE An **audit committee** is a selected number of members of a company's board of directors who provide a forum that is independent of management for both external and internal auditors. Most audit committees are made up of three to five or sometimes as many as seven directors. Incorporating Acts generally require that the audit committee must be independent outside directors (i.e., not part of company

Audit committee—selected members of a client's board of directors, who liase with and provide a forum for the auditors to remain independent of management.

management). Access to an active audit committee by internal and external auditors is one of the indicators of a healthy corporate governance structure. Most organizations that have debt or securities listed on a Canadian or American stock exchange (regardless of size) are required to have an audit committee consisting of at least three independent members who are also directors of the organization. Members of the audit committee are also required to be financially literate. The external auditor has the right to attend meetings of the audit committee and to call meetings if he or she feels they are necessary. Directors who become aware of any misstatements in issued financial statements must notify the auditor and the audit committee of the misstatements. A typical audit committee decides such things as which public accounting firm to retain and the scope of services the public accounting firm is to perform. The audit committee also meets with the public accounting firm to discuss the progress and findings of the audit and helps resolve conflicts between the public accounting firm and management. For the type of questions that directors would ask auditors, look at the 20 Questions Series, at **www.rogb.ca/director-series/20-question-series/index.aspx**.

At least annually, the auditor should inform the audit committee in writing of the following items: the level of the auditor's independence; all relationships between the auditor and his or her related business or practice and the entity and its related entities; and the total fees charged (separating out audit and non-audit services). The audit committee should also work directly with the internal auditors, approving their strategic plan and discussing their findings with them. The internal auditors should also be required to clarify the level of their independence.

AIDS TO MAINTAINING INDEPENDENCE The accounting profession and society, especially in the past decade, have been concerned about ensuring that (1) auditors maintain an unbiased attitude in performing their work (independence in fact) and (2) users perceive auditors as being independent (independence in appearance). Many of the elements shown in Figure 3-1 and other requirements or inducements encourage PAs to maintain independence in fact and appearance.

Legal liability The penalty involved when a court concludes that a practitioner is not independent can be severe, including criminal prosecution. The courts have certainly provided major incentives for auditors to remain independent. Legal liability is discussed in Chapter 4.

Rules of professional conduct The existing rules of conduct restrict PAs in their financial and business relationships with clients.

Generally accepted auditing standards Standards require the auditor to maintain an objective state of mind in all matters related to the assurance engagement.

Public accounting firm quality control processes Most public accounting firms establish policies and procedures to provide reasonable assurance that all engagement personnel are independent. Effective training, monitoring, and remedial action with respect to these processes help ensure compliance.

Audit committee An audit committee, as was discussed above, can help auditors remain independent of management.

Shopping for accounting principles Management may consult with other accountants on the application of accounting principles, often called "opinion shopping." Although consultation with other accountants is an appropriate practice, it can lead to a loss of independence in certain circumstances as a potential intimidation threat or self-interest threat. The existing auditor may feel intimidated if the new accounting treatment is not accepted. If a public accounting firm replaces the existing auditors on the strength of accounting advice offered but later finds facts and circumstances that require the public accounting firm change its position due to a self-interest threat, it may lose the client. The Auditing and Assurance Standards Board issued Section 7600, "Reports on the Application of Accounting Principles," setting out requirements that must be met when a public accounting firm is requested to provide a written opinion on the application of accounting principles or auditing standards by a party other than the client (also discussed in Chapter 20). Such an opinion would be issued for specific circumstances or transactions relating to an audit, review, or compilation client of another public accounting firm. It applies if the PA is asked to provide a generic or hypothetical opinion on the application of accounting principles, to make sure that both the incumbent auditor and the auditor providing the opinion have full information.

Approval of auditor by shareholders The Canada Business Corporations Act and other incorporating Acts require shareholders to approve the selection of a new auditor or the continuation of the existing one. Shareholders are usually a more objective group than is management.

Confidentiality

The rules of conduct for PAs state that members shall not disclose any confidential client information or employer information without the specific consent of the client or employer. The rules also prohibit using **confidential or inside information** to earn profits or benefits.

Confidential or inside information—client information that may not be disclosed without the specific consent of the client except under authoritative professional or legal investigation.

The rule against disclosure does not apply if the member is called upon to disclose the information by the courts. Communication between auditor and client is not privileged as it is between lawyer and client; a court can require a PA to produce all files and documents held, including confidential advice provided. For this reason, the auditor must take care with information put into the file, recognizing that the file could appear as a court document. The rule against disclosure also does not apply if the member's professional body requires the confidentiality rule to be waived in connection with the body's exercise of its duties (e.g., when an auditor is called upon to produce working papers in connection with the disciplinary process or when an auditor is required to produce files as part of practice inspection).

While the rules of professional conduct with respect to confidentiality are quite clear, as you will discover in Chapter 4, the auditor may be confronted with a situation where he or she must choose between confidentiality and other rules of conduct or another course of action.

NEED FOR CONFIDENTIALITY During an audit or other type of engagement, practitioners obtain a considerable amount of information of a confidential nature, including officers' salaries, product pricing and advertising plans, and product cost data. If auditors divulged this information to outsiders or to client employees who have been denied access to the information, their relationship with management would become strained and, in extreme cases, would cause the client harm. The confidentiality requirement applies to all services provided by public accounting firms, including tax and management services.

Ordinarily, the public accounting firm's working papers can be provided to someone else only with the express permission of the client. This is the case even if a PA sells his or her practice to another public accounting firm or is willing to permit a successor auditor to examine the working papers prepared for a former client. Permission is not required from the client, however, if the working papers are subpoenaed by a court or are used as part of practice inspection. If the working papers are subpoenaed, the client should be informed immediately. The client and the client's lawyer may wish to challenge the subpoena.

Maintenance of the Reputation of the Profession

The rules of accounting bodies in Canada require their members to behave in the best interests of their profession and the public. This means accountants should not take advantage of the trust placed in them. An accountant should not be publicly critical of a colleague (i.e., by making a complaint about the colleague's behaviour to their professional body or by being critical, as a successor auditor, to the new client) without giving the colleague a chance to explain his or her actions first.

Actions by a member of a professional body—in law, medicine, or any other profession—reflect not only on the member but also on the body. For example, a lawyer who steals trust monies sullies not only his or her own reputation but also that of the law profession; the theft brings all lawyers into disrepute. Reputation is affected by anti-social behaviour such as harassment and discrimination, since such behaviour is considered abhorrent, resulting in professional disciplinary actions. Therefore, it is essential that an accountant behave in an exemplary manner as a member of the professional body.

Integrity and Due Care

The rules of conduct for professional accountants require members to act with integrity and due care. Integrity is one of the hallmarks of the profession. One of a professional accountant's most important assets is his or her reputation for honesty and fair dealing; if users of financial statements audited by or prepared by an accountant do not believe in the practitioner's honesty or fairness, the value of the financial statements or the audit is diminished. The professional accountant's behaviour with clients, colleagues, employers, and employees must be above reproach.

Due care in the performance of duties is also a hallmark of a professional. The PA has a legal duty of care to certain users of financial statements, as will be seen in Chapter 4. Due care means the application by a professional of a level of care and skill in accordance with what would reasonably be expected of a person of his or her rank and training.

Competence

Professional accountants, including PAs, have a responsibility to maintain their professional competence. The rules of conduct require practitioners to maintain competence; similarly, GAAS state the necessity of "adequate technical training and proficiency in auditing." The public expects that all professionals will strive to keep abreast of the latest techniques and methodologies. An auditor should not undertake an audit of a client unless that auditor has both knowledge of that client's business and industry and of the technical aspects of the audit. For example, the audit of an insurance company requires knowledge of auditing the policy reserves that form a significant part of the insurance company's liabilities. Many larger accounting firms form industry specialization groups within the firm that are responsible for all audits within their specialty.

auditing in action 3 - 4

Practice Firm Argues about Lawsuit Disclosure

ABCD LLP, a medium-sized regional CA firm, was contacted by Amy, the corporate controller of a public company, about conducting the audit of Model Manufacturing Limited (MML). Amy had attended several external training events with members of the firm and was known to the partners of ABCD LLP. ABCD conducted a due diligence investigation and was informed by MML about the existence of a defective products lawsuit that was being vigorously defended. The lawsuit was disclosed in MML financial statements but had not been accrued. ABCD accepted the audit engagement and, upon corresponding with MML lawyers, found that a judgment had actually been issued against MML for $400,000, which should have been accrued in the previous quarterly financial statements. ABCD argued about the disclosure with MML, which finally agreed to accrue the amount when the lawyers supported ABCD's request. ABCD was so disenchanted with MML management's attitude about disclosure that it resigned after having completed the current year's audit engagement.

An audit firm should decline a new audit if the firm either lacks or does not have access to the technical knowledge required to complete the audit. Similarly, an auditor within a firm should ensure that he or she has access to the technical knowledge required to complete the audit.

Members are encouraged to keep current in a variety of ways. The various institutes and the *ordre* of chartered accountants have practice inspections (discussed in Chapter 1) over a three-year period of all public practice units. Professional accountants are required to attend a certain number of continuing professional education courses a year.

Adherence to Accounting Standards and GAAS

Professional accounting bodies require their members in practice as PAs and working in industry not to associate with false or misleading information or to fail to reveal material omissions from financial statements. PAs can lose faith in management when information is withheld, as described in Auditing in Action 3-4, and it then becomes difficult to complete the audit engagement. Users of financial statements prepared by or audited by professional accountants are entitled to believe that the financial statements are complete and fairly present the financial position of the company, to believe that the financial statements are not false and misleading, and to rely on the integrity of the accountants involved.

Given that public trust of professional accountants does exist, if an accountant betrayed this trust and provided a clean opinion on financial statements known to be misleading, users would accept the statements as correct and would suffer a loss. Discovery that the PA was associated with false and misleading financial information or failed to reveal a material fact would destroy the accountant's reputation for integrity.

PAs are required to comply with professional standards when preparing and auditing financial statements. These standards would include the standards of the professional body but, more importantly, accounting standards and GAAS as set out in the *CICA Handbook*. As you learned in Chapter 1, the Canada Business Corporations Act and the incorporating Acts of many of the provinces require financial statements to be prepared according to accounting standards in conformity with an applicable accounting framework as specified by the *CICA Handbook* and also require the auditor's report to be in accordance with the standards of the *CICA Handbook*. The Canadian Securities Administrators, who set policy for the securities commissions and stock exchanges in Canada, also specify the *CICA Handbook* as the source of accounting standards.

Advertising and Solicitation

A profession's reputation is not enhanced if the members openly solicit one another's clients or engage in advertising that is overly aggressive, self-laudatory, or critical of other members of the profession or that makes claims that cannot be substantiated. As a consequence, the professional accounting bodies in Canada either explicitly or implicitly prohibit solicitation of another PA's client and advertising that is not in keeping with the profession's high standards.

Responding to a request for information from a client of another public accounting firm is not solicitation, nor is responding to an invitation to tender from another firm's client. Rather, solicitation is approaching the client of another public accounting firm to convince him or her to switch to one's own firm; it is a targeted act of seeking a specific professional engagement.

Advertising that is in good taste is acceptable. It may include complimentary material about the accounting firm but should not claim any superior skills or make promises that cannot be kept (e.g., a promise that certain favourable results will be achieved). Advertising is a general process of informing potential users of the availability of services.

Other Rules

Breaches of the rules The rules of conduct of the professional accounting bodies require members who are aware of a breach of the rules by another member to report that member to the profession's discipline committee after first advising the member of the intent to make a report. The bodies are self-regulating. It is important that the member be notified of the intent to report the breach in case there are mitigating circumstances of which the reporting member is not aware.

Contingent fees The charging of a fee based on the outcome of an audit, such as the granting of a loan by a bank, could easily impair the auditor's independence. Contingent fees are prohibited for audits, reviews, and any other engagements that require the auditor to be objective.

Communication with predecessor auditor The rules of conduct of the PAs and incorporating Acts such as the Canada Business Corporations Act require a (potential) successor auditor, prior to accepting an appointment as auditor, to communicate with the incumbent auditor to inquire if there are any circumstances of which the incumbent is aware that might preclude the successor from accepting the appointment. The successor would ask the potential client to authorize the incumbent to provide the information requested. If the client refuses to do so, the successor should be reluctant to accept the appointment because it is likely that the client is hiding something.

The rules also require that the incumbent respond to the successor's request and be candid in responding. The communication between the incumbent and the successor is important because it prevents a successor from unknowingly accepting an appointment that might, if all the facts were known, be rejected. For example, if the incumbent resigned after finding that management of the client was dishonest and was engaged in fraud, it is unlikely any public accounting firm would accept the client if the incumbent passed on that knowledge. In short, the required communication protects prospective successors, and thus the profession, from getting involved with undesirable clients. Review of the previous auditor's working papers is an important part of the audit process, as discussed further in audit planning.

Professional liability insurance Members practising public accounting are required to carry professional liability insurance. Two issues arise that can cause confusion: defining public accounting and the extent of work being done without remuneration.

For example, during tax season, individuals may prepare tax returns for family and friends at no charge. Since basic advice such as maximization of RRSP contributions is often included, this process is considered to be practising public accounting. However, if only a limited number of returns are being prepared for no remuneration, a public practice is not being carried on. If more than a handful of returns are being prepared and fees are being charged, either on a full- or part-time basis, then professional liability insurance is required.

Other rules The rules of conduct of the professional accounting bodies include many more rules than have been described here; an aspiring professional accountant should be aware of the rules of conduct of the professional body of which membership is sought.

Enforcement

The rules of conduct for CAs are established and administered provincially. The rules of conduct for CGAs are promulgated by CGAAC. The provincial CGA associations have the power to add rules and have the responsibility for enforcing the rules.

As described in Table 3-4, the various professional bodies have the power to impose penalties ranging from public censure in the body's newsletter or requiring courses to be taken to upgrade skills to levying fines or expulsion. CPAB has the power to restrict a firm's ability to audit a listed entity. Since the professional accounting bodies are self-regulating, there is a danger that the public will perceive the disciplinary process as not being as stringent as it should be and that there is a reluctance to punish members who break the rules. This issue is being dealt with by including laypersons on the disciplinary committees and by the inspections supervised by CPAB. Information is also available to the public about findings of the discipline committees and actions taken by them.

concept check

C3-6 What are the five threats to independence? Describe each and provide an example.

C3-7 List three categories of safeguards to independence. Provide an example of each.

C3-8 Why are contingent fees prohibited for financial statement audits?

auditing in action 3 - 5

International Quality Control Requires Inspector Cooperation

We have talked about the PCAOB and the CPAB, organizations that are responsible for oversight of public company audits in the United States and in Canada. There are similar oversight bodies around the world, such as the *Professional Oversight Board* in the United Kingdom.

As we will discuss later in this book, auditors of an organization may rely upon specialists (for example an inventory specialist in a jewelry store, or a pension specialist to evaluate pension liabilities). Auditors could also rely upon auditors in other offices around the world, auditors from their own firm or from other firms, to conduct the audit of international organizations. International audits require international quality control, both from the organization doing the audit, and from oversight bodies.

If an organization has a head office in London, England, it may be that the U.K oversight board would be the responsible quality control reviewer, while an organization in Canada would have the CPAB responsible. If the CPAB is responsible, it might choose to rely upon the working papers of quality control inspections completed by another organization, such as the PCAOB. This means that the CPAB would want to be certain about the quality of the inspection completed in the other country, and potentially have access to the working papers. Laws and procedures have, in fact, been developed so that these organizations can rely upon each other's work.

Source: G. Jeffrey, (March 2011) "Countries agree to share audit data," *The Bottom Line*, p. 5; Professional Oversight Board, **www.frc.org.uk/pob/**.

Summary

1. *What are ethics and why are they important?* Ethics are broad moral principles or values that help guide our behaviour and establish trustworthy, responsible, and fair relationships.

   How can I work through an ethical conflict (known as an ethical dilemma)? Two approaches are discussed in this chapter. A six-step framework that walks through information collection, analysis, and a decision is provided, as well as a five-step proactive approach that encourages resolution of the dilemma (identification, purpose and choice, stakeholder analysis, powerful response, and scripting and coaching).

2. *How are PAs different from other professionals?* The clients of PAs are individuals as well as management of corporations. In addition, PAs have a responsibility to users of financial statements such as shareholders and creditors. This is a more expanded responsibility than that of other professionals.

   What is the role of a code of professional conduct in encouraging accountant ethical behaviour? Such a code of conduct can have general statements of ideal conduct and specific rules that define unacceptable behaviour.

3. *What are the threats to independence?* There are five areas where independence must be considered: self-interest, self-review, advocacy, familiarity, and intimidation.

   How does the auditor's relationship with the audit committee affect independence? The audit committee can help the auditor remain independent of management by making the auditor retention decision, approving the services provided by the PA, discussing the audit progress and findings, and by helping to resolve conflicts between the public accounting firm and management.

   What are some of the key rules of professional conduct and how they are enforced? There are rules of professional conduct covering independence, confidentiality, maintenance of the reputation of the profession, integrity and due care, competence, adherence to professional standards, and advertising and solicitation. Rules of conduct are enforced by the professional accounting associations and by CPAB.

MyAccountingLab

Make the grade with MyAccountingLab: The questions, exercises, and problems marked in orange can be found on MyAccountingLab. You can practise them as often as you want, and most feature step-by-step guided instructions to help you find the right answer.

Review Questions

3-1 1 Using Table 3-1, explain how a professional accountant would embody each of the illustrated ethical principles.

3.2 1 When analyzing an ethical dilemma, why is a structured approach helpful?

3-3 2 Identify and explain factors that should keep the quality of audits high, even though advertising and tendering are allowed.

3-4 3 Distinguish between independence in fact and independence in appearance. State three activities that may not affect independence in fact but are likely to affect independence in appearance.

3-5 3 Why is an auditor's independence so essential?

3-6 3 What organization is responsible for developing ethics standards for accountants at the international level? What are the fundamental principles of the international ethics standards?

3-7 3 What consulting or nonaudit services are prohibited for auditors of public companies? What other restrictions and requirements apply to auditors when providing nonaudit services to public companies?

3-8 3 What is an independence threat analysis? When and why should it be completed?

3-9 3 Many people believe that a PA cannot be truly independent when payment of fees is dependent on the management of the client. Explain a way of reducing this appearance of lack of independence.

3-10 3 The auditor's working papers usually can be provided to someone else only with the permission of the client. What is the rationale for such a rule? What are the exceptions to this rule?

3-11 3 The rules of conduct of professional accountants require them to report a breach of the rules of conduct by a member to their profession's disciplinary body. What should they do before making such a report?

3-12 3 After accepting an engagement, a PA discovers that the client's industry is more technical than at first realized and that he or she (i.e., the accountant) is not competent in certain areas of the operation. What should the PA do in this situation?

3-13 3 For what types of engagements are contingent fees acceptable as charged by professional accountants?

3-14 3 Why is it so important that a successor auditor communicate with the incumbent before accepting an appointment as auditor? What should the successor do if the incumbent does not reply?

Discussion Questions and Problems

3-15 1 2 Diane Harris, a PA, is the auditor of Fine Deal Furniture, Inc. In the course of her audit for the year ended December 31, 2011, she discovered that Fine Deal had serious going-concern problems. Henri Fine, the owner of Fine Deal, asked Diane to delay completing her audit.

Diane is also the auditor of Master Furniture Builders Ltd., whose year end is January 31. The largest receivable on Master Furniture's list of receivables is Fine Deal Furniture; the amount owing represents about 45 percent of Master Furniture's total receivables, which, in turn, are 60 percent of Master Furniture's net assets. The management of Master Furniture is not aware of Fine Deal's problems and is certain the amount will be collected in full.

Master Furniture is in a hurry to get the January 31, 2011, audit finished because the company has made an application for a sizable loan from its bank to expand its operations. The bank has informally agreed to advance the funds based on draft financial statements submitted by Master Furniture just after the year end.

REQUIRED

What action should Diane take and why?

3-16 3 The following situations involve the provision of non-audit services. Indicate whether providing the service is a violation of the rules of professional conduct for PAs. Explain your answer.

a. Providing bookkeeping services to a listed entity. The services were preapproved by the audit committee of the company.
b. Providing internal audit services to a listed entity that is not an audit client.

c. Designing and implementing a financial information system for a private company.
d. Recommending a tax shelter to a client that is a publicly held listed entity. The services were preapproved by the audit committee.
e. Providing internal audit services to a listed entity audit client with the preapproval of the audit committee.
f. Providing bookkeeping services to an audit client that is a private company.

3-17 3 Each of the following scenarios involves a possible violation of the rules of conduct. Indicate whether each is a violation and explain why you think it is or is not.

a. John Brown is an PA, but not a partner, with three years of professional experience with Lyle and Lyle, Public Accountants, a one-office public accounting firm. He owns 25 shares of stock in an audit client of the firm, but he does not take part in the audit of the client and the amount of stock is not material in relation to his total wealth.
b. In preparing the corporate tax returns for a client, Phyllis Allen, a PA, observed that the deductions for contributions and interest were unusually large. When she asked the client for backup information to support the deductions, she was told, "Ask me no questions, and I will tell you no lies." Phyllis completed the return on the basis of the information acquired from the client.
c. A private entity audit client requested assistance of Kim Tanabe, a PA, in the installation of a computer system for maintaining production records. Kim had no experience in this type of work and no knowledge of the client's production records, so she obtained assistance from a computer consultant. The consultant is not in the practice of public accounting, but Kim is confident of her professional skills. Because of the highly technical nature of the work, Kim is not able to review the consultant's work.
d. Five small Moncton public accounting firms have become involved with an information project by taking part in an interfirm working paper review program. Under the program, each firm designates two partners to review the working papers, including the tax returns and the financial statements, of another public accounting firm taking part in the program. At the end of each review, the auditors who prepared the working papers and the reviewers have a conference to discuss the strengths and weaknesses of the audit. They do not obtain the authorization from the audit client before the review takes place.
e. Roberta Hernandez, PA, serves as controller of a Canadian company that has a significant portion of its operations in several South American countries. Certain government provisions in selected countries require the company to file financial statements based on international standards. Roberta oversees the issuance of the company's financial statements and asserts that the statements are based on international financial accounting standards; however the standards she uses are not those issued by the International Accounting Standards Board.
f. Bill Wendal, a PA, set up a casualty and fire insurance agency to complement his auditing and tax services. He does not use his own name on anything pertaining to the insurance agency and has a highly competent manager, Renate Jones, who runs it. Bill frequently requests Renate to review with the management of an audit client the adequacy of the client's insurance if it seems underinsured. He feels that he provides a valuable service to clients by informing them when they are underinsured.
g. Michelle Rankin, a PA, provides tax services, management advisory services, and bookkeeping services and conducts audits for the same private company client. She requires management to approve, in writing, transactions and journal entries. Since her firm is small, the same person frequently provides all the services.

3-18 3 Each of the following situations involves possible violations of the rules of conduct that apply to professional accountants. For each situation, state whether it is a violation. Where there is a violation, explain the nature of the violation and the rationale for the existing rule.

a. Martha Painter, a PA, was appointed as the trustee of the So family trust. The So family trust owned the shares of the So Manufacturing Company, which is audited by another partner in Martha's office. Martha owns 15 percent of the shares of the So Manufacturing Company and is also a director of the company, in the position of Treasurer.
b. Marie Godette, LLB, has a law practice. Marie has recommended one of her clients to Sean O'Doyle, a PA. Sean has agreed to pay Marie 10 percent of the fee Sean receives from Marie's client.
c. Theresa Barnes, a PA, has an audit client, Choi, Inc., which uses another public accounting firm for management services work. Unsolicited, Theresa sends her firm's literature covering its management services capabilities to Choi on a monthly basis.
d. Alan Goldenberg leased several vehicles from his friend Norm. Norm said that he would give Alan a $200 commission for each referral. Alan referred to Norm several clients who were interested in leasing vehicles. After a few months, Alan was pleased to receive a cheque for $3,000 in the mail. Several of his clients had decided to change automobile leasing companies.
e. Edward Golikowski completed for his client financial projections that covered a period of three years. Edward was in a hurry and inadvertently stated that they covered five years; so he redid the client's calculations, rather than

checking assumptions and doing field work, even though he attached an assurance report.

f. Marcel Poust, a PA, has sold his public accounting practice, which includes bookkeeping, tax services, and auditing to Sheila Lyons, a PA. Marcel obtained permission from all audit clients for audit-related working papers before making them available to Sheila. He did not get permission before releasing tax- and management services-related working papers.

3-19 3 Ann Archer serves on the audit committee of JKB Communications Inc., a telecommunications start-up company. The company is currently a private company. One of the audit committee's responsibilities is to evaluate the external auditor's independence in performing the audit of the company's financial statements. In conducting this year's evaluation, Ann learned that JKB Communications' external auditor also performed the following IT and e-commerce services for the company:

1. Installed JKB Communications' information system hardware and software selected by JKB management.
2. Supervised JKB Communications' personnel in the daily operation of the newly installed information system.
3. Customized a prepackaged payroll software application, based on options and specifications selected by management.
4. Trained JKB Communications' employees on the use of the newly installed system.
5. Determined which of JKB Communications' products would be offered for sale on the company's internet website.
6. Operated JKB Communications' local area network for several months while the company searched for a replacement after the previous network manager left the company.

REQUIRED

Consider each of the preceding services separately. Evaluate whether the performance of each service is a violation of the rules of professional conduct.

3-20 3 The following are situations that may violate the general rules of conduct of professional accountants. Assume in each case that the PA is a partner.

1. Simone Able, a PA, owns a substantial limited partnership interest in an apartment building. Juan Rodriquez is a 100-percent owner in Rodriquez Marine Ltd. Juan also owns a substantial interest in the same limited partnership as Simone. Simone does the audit of Rodriquez Marine Ltd.
2. Horst Baker, a PA, approaches a new audit client and tells the president that he has an idea that could result in a substantial tax refund in the prior year's tax return by application of a technical provision in a tax law that the client had overlooked. Horst adds that the fee will be 50 percent of the tax refund after it has been resolved by Canada Revenue Agency. The client agrees to the proposal.
3. Chantal Contel, a PA, advertises in the local paper that her firm does the audit of 14 of the 36 largest drugstores in the city. The advertisement also states that the average audit fee, as a percentage of total assets for the drugstores she audits, is lower than that of any other public accounting firm in the city.
4. Olaf Gustafson, a PA, sets up a small loan company specializing in loans to business executives and small companies. Olaf does not spend much time in the business because he works full time in his public accounting practice. No employees of Olaf's public accounting firm are involved in the small loan company.
5. Louise Elbert, a PA, owns a material amount of stock in a mutual fund investment company, which, in turn, owns stock in Louise's largest audit client. Reading the investment company's most recent financial report, Louise is surprised to learn that the company's ownership in her client has increased dramatically.

REQUIRED

Discuss whether the facts in any of the situations indicate violations of the rules of conduct for professional accountants. If so, identify the nature of the violation(s).

Professional Judgment Problems

3-21 3 Donna, a PA, is approached by the owner of one of her clients, for whom she normally compiles monthly and annual financial statements, to perform an audit of the company's inventories. The client, Fantastic Fashions Ltd., is a chain of retail clothing stores that operates in several local shopping malls. The owner explains that he is seeking new bank financing that will be secured by the inventories as collateral for the loan, and that the bank has requested an audit of the recorded inventories as a condition of granting the loan. The bank insists that it will lend no more than 75 percent of the amount of inventories as shown on an audited schedule of inventories that the owner has been asked to submit. Because the owner is in urgent need of cash, he offers to pay Donna an audit fee equal to 10 percent of the loan amount, and Donna agrees to these terms. She then performs an audit of the inventories in accordance with generally accepted auditing standards, and issues a standard unqualified audit opinion, except that the opinion paragraph reads as follows: "In my opinion, this schedule presents fairly, in all material respects, the inventories of Fantastic Fashions Ltd. as at March 31, 2012, in accordance with generally accepted accounting standards for private enterprises."

REQUIRED

Discuss whether Donna has violated the rules of conduct for professional accountants. If so, identify the nature of the violation(s).

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3-22 3 Joseph Smith was the chairman and chief operating officer of Maximum Software Limited, providing software solutions to companies in Manitoba. Joseph owned 40 percent of the company and had several silent partners who sat on the board of directors but did not participate in the company's operations. The chief financial officer of Maximum was Barbara Black, who had been with the company since its inception ten years ago.

Joseph was short of money, so he created a fictitious company and requested that Barbara send monthly cheques of $10,000 to this company, called Network Best, for consulting fees. Barbara agreed since Joseph approves the invoices. The controller, Samuel Chu, was a single parent with three children. Samuel did a normal credit check on Network Best and told Barbara that the company did not exist and the invoices should not be paid. Barbara berated Samuel and told him to keep quiet or he would lose his job. Joseph billed amounts through Network Best for three years.

REQUIRED

Assuming that all of the individuals described are qualified accountants, what rules of professional conduct were violated? What should Barbara or Samuel have done?

Case

3-23 1 2 3 Barbara Whitley had great expectations about her future as she sat at her graduation ceremony in May 2011. She was about to receive her Master of Accountancy degree, and the following week she would begin her career on the audit staff of Green, Thresher & Co., a public accounting firm. Things looked a little different to Barbara in February 2012. She was working on the audit of Delancey Fabrics Ltd., a textile manufacturer with a calendar year end. The pressure was enormous. Everyone on the audit team was putting in 70-hour weeks, and it still looked as if the audit would not be done on time. Barbara was doing work in the property area, vouching additions for the year. The audit program indicated that a sample of all items over $10,000 should be selected, plus a non-statistical sample of smaller items. When Barbara went to take the sample, Jack Bean, the senior, had left the client's office and could not answer her questions about the appropriate size of the judgmental sample. Barbara forged ahead and selected 50 smaller items on her own judgment. Her basis for doing this was that there were about 250 such items, so 50 was a reasonably good proportion of such additions. Barbara audited the additions with the following results: The items over $10,000 contained no errors; however, the 50 small items contained a large number of errors. In fact, when Barbara projected them to all such additions, the amount seemed quite significant.

A couple of days later, Jack Bean returned to the client's office. Barbara brought her work to Jack in order to inform him of the problems she found, and got the following response: "My God, Barbara, why did you do this? You were supposed to look only at the items over $10,000, plus 5 or 10 little ones. You've wasted a whole day on that work, and we can't afford to spend any more time on it. I want you to throw away the schedules where you tested the last 40 small items and forget you ever did them."

When Barbara asked about the possible audit adjustment regarding the small items, none of which arose from the first 10 items, Jack responded, "Don't worry, it's not material anyway. You just forget it; it's my concern, not yours."

REQUIRED

a. In what way is this an ethical dilemma for Barbara?
b. Use the five-step Giving Voice to Values approach discussed in the chapter to resolve the ethical dilemma.

Ongoing Small Business Case: Quitting the Firm to Start CondoCleaners.com

3-24 3 Jim has been thinking about CondoCleaners.com for the last three months now. He has been a bit distracted at work and has had some difficulty concentrating, as he has started organizing a request for proposal for his new website and for a market study to help him plan his approach. After discussions with the firm's personnel partner, he decided to give the firm four months' notice, rather than leaving in the middle of a busy season. The firm is sorry to see him go and has said that there will always be a job there for him. Jim is wondering if he should ask the current client he is working on, a marketing company, to complete a market survey for him.

REQUIRED

Explain why or why not Jim should use the services of his firm's audit client for the CondoCleaners.com market study. What other potential quality control or independence issues are caused by Jim's proposed new business?