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03. Threats and Safeguards to the Fundamental Ethical Principles

After studying this module you will be able to:

- identify the key threats to the fundamental ethical principles and know how to evaluate whether a threat is at an acceptable level;
- select appropriate safeguards to address threats identified;
- identify different types of safeguards at industry, firm and individual level; and
- take an appropriate course of action if the threats outweigh safeguards

Threats and Safeguards to the Fundamental Ethical Principles

1. Overview
2. Safeguards
3. Advocacy
4. Self interest
5. Intimidation
6. Familiarity
7. The ICAEW Code of Ethic's approach to ethical threats
8. Review

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3.1.1 Overview

VIDEO – Dealing with threats

The varied nature of the work that chartered accountants do creates specific threats to compliance with the fundamental ethical principles covered in Module 2.

Think of any professional situation you might come across at work and there will be a potential threat that exists that could cause you to not comply with one or more of the fundamental ethical principles.

For this reason the ICAEW Code of Ethics includes a conceptual framework that helps you to identify, evaluate, and address threats to compliance with the fundamental principles.

The key threats identified in the framework are:

1. **A**dvocacy
2. **S**elf Interest
3. **S**elf Review
4. **I**ntimidation
5. **F**amiliarity.

You may find the mnemonic **ASSIF** useful to remember these threats.

nb In addition to these five threats, The Auditing Practice Board's Ethical Standards also identify a management threat. This is covered in section 3.4.

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3.1.2 Overview

Learning outcomes

After studying this module you will be able to:

1. identify the key threats to the fundamental ethical principles and know how to evaluate whether a threat is at an acceptable level;
2. select appropriate safeguards to address threats identified;
3. identify different types of safeguards at industry, firm and individual level; and
4. take an appropriate course of action if the threats outweigh the safeguards.

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3.2.1 Safeguards

To help mitigate threats to the fundamental ethical principles so that they are at an acceptable level, you should apply safeguards.

A safeguard is any action or practice that helps to mitigate an ethical threat.

Safeguards exist to help you at a profession, and a work-environment level.

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3.2.2 Safeguards

Profession-level safeguards

Safeguards have been created by the profession, including legislation and regulations. For example, International Standards on Auditing outline a number of procedures that statutory auditors are expected to follow, which help to promote ethical behaviour.

Ethical standards for auditors

Other examples of safeguards at this level include:

1. education and training;
2. continuing professional development requirements;
3. professional standards;
4. regulatory monitoring; and
5. corporate governance regulations.

- Education and training
- Continuing professional development (CPD)
- Professional standards
- Regulatory monitoring
- Corporate governance regulations

Education and training

Education is a key element of the ACA qualification. Ethics is covered in all of the modules of the ACA qualification.

Continuing professional development (CPD)

All chartered accountants must keep their professional knowledge up to date throughout their careers. This includes ethical training.

Professional standards

The industry has a number of professional standards that you are expected to adhere to. For example International Financial Reporting Standards (IFRSs) and International Standards on Auditing (ISAs) help to promote ethical reporting and behaviour.

Regulatory monitoring

Regulators including ICAEW's Quality Assurance Department (QAD) monitor ethical behaviour among firms and individuals.

Corporate governance regulations

The Combined Code in the UK and the Sarbanes-Oxley Act for US affiliated firms, are two examples of corporate governance codes and regulations that were brought in following the Enron accounting scandal to improve ethical behaviour in business.

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3.2.3 Safeguards

Work-environment safeguards

Work-environment safeguards are those which are in place across the whole of a firm. In the workplace the relevant safeguards will vary depending upon the circumstances.

Examples of work-level safeguards include:

1. leadership of the firm that stresses the importance of complying with the fundamental ethical principles and acting in the public interest;
2. entity-wide internal policies and procedures which are communicated clearly to staff on a timely basis;
3. appointing senior management to oversee a firm's quality control system;
4. strong internal controls;
5. having a reward and disciplinary mechanism to promote compliance with internal policy and regulations;
6. robust recruitment and training processes; and
7. transparency and disclosure.

For an additional layer of work-environment safeguards, practice firms can also have engagement-specific safeguards, which include:

1. reviews by professional accountants not involved in the engagement;
2. rotating senior staff off the engagement on a periodic basis; and
3. compulsory discussion of ethical issues with the client's senior management and audit committees.

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3.3.1 Advocacy

An advocacy threat is one where your objectivity is at risk of being compromised due to you promoting employers or other firms.

Examples of common situations where you may be at risk from advocacy threats are:

1. managing share issues;
2. endorsing products or services;
3. providing references about a client to a third party (this does not include the audit opinion); and
4. acting as an advocate on behalf of audit clients in litigation or disputes with third parties.

Advocacy threats are particularly relevant to branches of accountancy where independence is required, in particular where an accountancy firm is acting as external auditors to the client.

Being seen to be objective

Threats to the fundamental ethical principles can arise when you are put in a position where your actions may be seen to be compromising your objectivity.

You may be 100% satisfied that you have adopted an objective mindset, but you may still face disciplinary action if you are not seen to be taking appropriate steps to manage potential threats.

For example, consider a situation where an audit partner is asked to provide the finance director of an audit client with a written reference for a personal bank loan application. The audit partner themselves may be satisfied that this will not affect their approach to future work that they carry out on that client's engagements.

However someone outside the organisation, such as a shareholder, may argue that providing a reference would be an act of advocacy and potentially even familiarity. This could potentially place the audit partner in an awkward situation.

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3.4.1 Self interest

Self interest means that your own interests will inappropriately influence your judgement or behaviour.

There are two main types of self interest: financial and non-financial.

Financial interest

Financial self interest occurs when you or your firm has a financial interest in the performance of your client or employer.

There will always be some financial self interest threat given that you earn your fees from clients. However, significant self interest threats arise when a firm is so reliant on the income from a client that it might be tempted to engage unethical behaviour to keep them.

To help mitigate this threat the Code recommends that firms reduce their financial exposure to clients where they believe this threat applies. The APB Code of Ethics goes further and recommends that firms should never allow more than 15% of their income to come from one client (for audit firms no more than 10% of their income for a listed client).

Audit firms should also never receive fees from clients which are contingent on their financial results.

Financial self interest can also occur on an individual level, such as when you own shares in the client or when your fee is dependent on the financial performance of the client.

To prevent the risk of inappropriate ethical behaviour, you should not have a personal financial interest in your clients. However if you are a professional accountant working in business you will, naturally, have an unavoidable financial interest in your employer.

Non-financial interest

Non-financial self interest threats usually relate to personal relationships. These threats usually arise when you have a close personal relationship with a member of the client's staff who is in a position to influence the company's financial statements. Usually this would include immediate family, partners and spouses.

Other examples of circumstances where there may be a personal interest threat include when you enter into employment negotiations with a client.

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3.4.2 Self interest

Could you date your client?

If you date a member of your client's staff, would you breach your duty to the ICAEW Code of Ethics?

Technically, as long as the staff member isn't in a position to influence the financial statements then there is unlikely to be an issue as far as the Code is concerned (if they are in a position to influence the financial statements, however, then there may be a familiarity threat). Nevertheless it would be a good idea to inform the rest of your team before you continue working on the engagement.

As a general rule if you have any doubts about whether you might be subject to an ethical threat, then it is always good idea to check with your team or line manager first.

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3.4.3 Self interest

Be honest, how easy would you find it to be objective about your own piece of work? Even if you thought that you were being objective, how would you know if you really were?

A self-review threat can occur when you or your firm review your own work. When this happens there is a risk that you may not appropriately evaluate the results of a previous judgement or service performed. This could lead to mistakes being overlooked or even covered up.

You and your firm should always seek to avoid being put in a position where you may end up reviewing your own work.

Information barriers

Often an accountancy firm may provide more than one service to a client, which can leave it exposed to a self-review threat. A firm can reduce this threat by having information barriers. Often referred to as Chinese Walls these are used where a firm has two separate engagements with the same client.

Information barriers involve the firm using separate engagement teams, with separate lead partners, ideally from separate offices. There should be no contact between the two teams in relation to the client concerned.

The management threat

In addition to the five threats mentioned in the ICAEW Code of Ethics, the APB's Ethical Standards mention a management threat separately from the self-review threat.

You are often asked for advice on a wide range of issues by clients. This is fine in itself but it can become a problem when you act as an external auditor. When this happens there is a risk that you may become involved in making management decisions on behalf of the client, which could create a self-review threat.

The following situations might be indicators that you are taking on management responsibilities in an organisation.

1. Setting policies and strategic direction.
2. Directing and taking responsibility for the actions of the entity's employees.
3. Authorising transactions.
4. Deciding which recommendations of the firm or other third parties to implement.
5. Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
6. Taking responsibility for designing, implementing and maintaining internal control.

For example if an auditor were to advise their client on which accounting system would best suit their business it would then be difficult for the auditor to objectively assess the effectiveness of this system if the client started to use it.

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3.5.1 Intimidation

Intimidation occurs when you are put under pressure by a client or employer to act in a favourable manner ie, that is not objective.

Intimidation threats can take many forms and can be very difficult to manage. It may take the form of a director with a dominant personality, or it could be a subtle threat.

As a professional accountant it is important that you are able to recognise the signs of an intimidation threat, and be able to deal with these in an appropriate and professional manner.

Remember that you can take the following steps if you do encounter a potential intimidation threat.

1. Discuss the issue with your senior/colleagues in the first instance.
2. If there is a valid intimidation threat then discuss the issue with someone senior to the member of client staff who has initiated the threat.
3. If there is no one more senior in the client's organisation, approach the client's non-executive directors and audit committee.
4. If the issue can't be satisfactorily resolved then the professional accountant could, as a last resort, resign from the engagement.

Undercutting

Clients may often put pressure on accountancy firms to lower the fees that they charge. It is common for work to be put out to tender by clients looking to secure the best value for their fee.

It is therefore tempting for accountancy firms to submit low fee quotes to win new work, in the hope that it may lead to other more lucrative engagements. There is nothing wrong with this practice in itself as long as you don't "cut corners" when performing the accountancy work to save money – this would be a threat to the professional competence principle.

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3.5.2 Intimidation

Real-life case study

You are a sole practitioner who has recently accepted an engagement to prepare the financial statements for a private medium-sized company. Their chief financial officer has been signed off on long-term sick leave. The company is looking to expand and is seeking to obtain a new bank loan.

After a few days at the client's premises it becomes apparent that the chief executive officer is expecting you to show the company in a more favourable light than is actually the case. On several occasions he has told you that he will put next year's engagement out to tender if the current net assets position in the draft financial statements does not improve significantly.

In this situation it is clear that a very real intimidation threat exists. If the company has an audit committee then you should discuss the issue with them. If there is no audit committee then you could discuss the matter with the non-executive directors if you judge that they have sufficient influence over the CEO.

Unless the CEO can be removed from the financial reporting process it will be very difficult for the professional accountant to continue on this engagement and they should consider resigning from the role.

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3.5.3 Intimidation

This case study explores issues surrounding integrity and objectivity at work, involving a situation that you may find yourself in at work.

Ask yourself the following questions as a business professional:

1. What does integrity mean for you?
2. Is integrity the core principle in professional behaviour?
3. How is integrity installed in your own organisation? Does it always work?

Objectives

Once you have completed this case study you should be able to:

1. Recognise your responsibilities as a professional when working as an employee of the company
2. Seek appropriate sources of guidance
3. Apply what you have learned to your own experiences at work

Background

Ranjit is a newly qualified ACA. He works in the accounts department of a small outdoor clothing company. For weeks speculation has been rife around the company that they are about to be sold to a much larger conglomerate in a multi-million pound deal. One morning the Managing Director, James Delfino, (who is also a significant shareholder) pays Ranjit a visit.

Characters

Ranjit Desai: Accountant

James Delfino: Managing Director

SCENE 1:

James: Ranjit, I've just been reviewing your year-end inventory valuation calculation and I'm rather concerned. The figure is much lower than I was expecting, and 20% lower than last year!

Ranjit: Yes I can explain that, James. During my stockcount I noticed that a number of clothing lines have been sat in the warehouse for more than 18 months. To be honest we should have really created a provision for them last year

James: What nonsense! I know this is the first time you have looked after our inventory but I'm wondering now whether you're ready to do this! Those items are still in good condition and will sell this year. I want you to remove the provision.

Ranjit: Well... I'm sorry James, I thought I was doing the right thing.

Ranjit: I just don't see how we can be so confident about such slow moving stock?

Ranjit: When I was studying for my exams I was taught that a provision should be recognised if net realisable value falls below original cost.

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James: Listen, Ranjit, if you want to succeed here you are going to have to learn very quickly that the real world is very different to what you may read in your accountancy books. Please remove that provision and send me the revised year-end inventory figure.

1

Question

Should Ranjit seek further advice?

Note down reasons for your answer

Answer

There is potentially a conflict of interest here. A higher inventory figure would help to increase the value of the company and profitability. Ranjit is coming under pressure from the Managing Director to act in a way that may compromise his integrity and professional competence. Understandably though, he is reluctant to go against the Managing Director's wishes.

Ranjit should seek advice from either his line manager, or another senior member of the organisation who he trusts. He could also consult with ICAEW to discuss an appropriate course of action.

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3.6.1 Familiarity

An aeroplane takes off, piloted by a crew who know each other very well. A few minutes later an engine warning light comes on. The pilot explains to the crew that this is simply due to a frequently occurring electrical fault in this particular aircraft and there is no need for concern. Knowing the pilot as they do, the crew accepts his judgement. A few minutes later a second warning light comes on. Again the pilot reassures the crew that this is perfectly normal and there is no need to turn back. A few minutes later the plane disappears off the radar without a trace …

Familiarity is the threat that you will lose your objectivity towards a client or employer because you are too close to them.

This threat tends to occur when you become too close to senior management, or to those who can influence the financial statements.

So why is familiarity an issue?

1. You may accept new work from the client without giving due consideration to whether you should.
2. Professional scepticism may be lost - potential issues may be overlooked if you are too trusting of the client.
3. You may become too sympathetic to the client's own interests.

As a general rule audit partners should consider rotating themselves off engagements at least once every 10 years to help mitigate the familiarity threat.

The Auditing Practice Board's Ethical Standards requires key audit partners and senior managers of listed clients to rotate every five years and seven years respectively. Once they have been rotated they may not return to the engagement for at least five years.

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3.6.2 Familiarity

Join the debate: compulsory audit rotation

Should audit firms be made to rotate from clients on a regular basis? There are valid arguments on both sides.

Compulsory audit firm rotation would help to improve objectivity in the audit process. A new audit firm would remove the risk of familiarity and a fresh audit approach may facilitate more comprehensive audits.

On the other hand, audit rotation would cause firm's cumulative knowledge of the client to be lost from the audit process, leading to more less effective audits which might become more expensive for clients.

What do you think?

Professional scepticism

Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

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3.7.1 The ICAEW Code of Ethic's approach to ethical threats

The ICAEW Code of Ethics recommends an approach for you to follow when dealing with ethical threats.

Gather the relevant facts and identify the problem

Find out as much about the situation as you can in order to clarify and identify the problem and the key issues.

Ask yourself the following questions:

- Do I have all the facts relevant to the situation?
- Am I making assumptions? If so, could facts be identified to replace these assumptions?
- Is it really your problem? Can anybody else help?

If relevant facts are not readily available, you may be able to get more background information to address the limitations by:

- referring to the organisation's policies, procedures, code of conduct and previous history
- discussing the matter with other appropriate people such as trusted colleagues and managers

Identify the relevant parties

- Who are the individuals, organisations and key stakeholders affected?
- In what way are they affected?
- Are there conflicts between different stakeholders?
- Who are your allies?

Those affected may include, but are not limited to, employees, employers, shareholders, consumers, clients or customers, investors, government and the community at large.

Consider the ethical issues involved

- Have you considered the ICAEW Code of Ethics?
- What are the professional, organisational and personal ethics issues?
- Would these ethical issues affect the reputation of the accountancy profession?
- Would these ethical issues affect the public interest?

Use the information collected to identify the key personal, professional and organisational ethical issues involved.

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Identify which Fundamental Principles are affected

Clarify the ethical issues by considering which of the five Fundamental Principles (integrity, objectivity, professional competence and due care, confidentiality and professional behaviour) are under threat in this particular situation.

- Are the threats to compliance with the Fundamental Principles clearly insignificant?
- Are there safeguards which can eliminate or reduce the threats to an acceptable level?

Refer to your employing organisation's internal procedures

- Do your organisation's policies and procedures provide guidance on the situation?
- How can you escalate concerns within the organisation?
- Does the organisation have a whistleblowing procedure?

At what point should you seek guidance from external sources such as ICAEW?

As a student, you would normally raise any ethical issues with your immediate supervisor or manager. Alternatively discuss them with your counsellor, training partner, ethics partner or equivalent if there is one.

There may also be other parties within your organisation with whom it might be appropriate for the issues to be discussed, eg an audit committee or other corporate governance body, or specialist departments such as legal, audit or human resources. It is likely, however, that as a student it would be inappropriate to approach such parties without the consent of your supervisor or manager.

Consider and evaluate alternative courses of action

Consider the available courses of action and their consequences. In particular you should consider the organisation's policies, procedures and guidelines and any applicable laws or regulations. You will also need to bear in mind the universal values and principles widely adopted by society and think about the long and short-term consequences as well as any private, public or symbolic consequences (ie, the statements you might be making by taking a particular course of action).

When evaluating a course of action it is important to test the adequacy of the approach by considering whether:

- all the consequences have been discussed and evaluated
- the action will stand the test of time
- a similar course of action would be undertaken in a similar situation
- you would feel comfortable with scrutiny from peers, family and friends.

Decide on a course of action and monitor its progress

Having considered all of these issues you need to determine the most appropriate course of action that is consistent with the Fundamental Principles identified and to implement this decision.

As a student, however, it is unlikely that you will have to take the ultimate decision yourself. This is likely to be reached in consultation with your manager, counsellor, training partner, ethics partner or equivalent.

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Document

You should document the whole process including your thoughts, any discussions and the decisions reached. Keeping records is not formally part of the ethical decision making framework but you may need them at a later date, either to justify your course of action or as part of an ongoing review of the situation.

Learn from your experience

You should of course always find out if the consequences of any decisions were what you expected them to be (and if not, why not?) to learn for the future.

- Are the threats to compliance with the Fundamental Principles clearly insignificant?
- Are there safeguards which can eliminate or reduce the threats to an acceptable level?

This is not the only ethical decision making framework but it does provide a useful tool to help assess a situation and determine a course of action.

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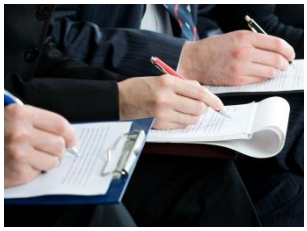
3.8.1 Review

This module has covered the five main threats to the fundamental ethical principles and the approach that professional accountants should take when they encounter such threats. The mnemonic **ASSIF** may help you to remember the five main threats: advocacy, self-interest, self-review, intimidation, familiarity.

This module is linked to section 1 of the ICAEW Code of Ethics.



The key learning points of this module are summarised below.

1. An advocacy threat is one where the professional accountant's objectivity is at risk of being compromised due to them being seen to promote a client.
2. Self-interest means that a professional accountant's own interests will inappropriately influence their judgement or behaviour.
3. A self-review threat can occur when a professional accountant or firm reviews their own work. When this happens there is a risk that the professional accountant may not appropriately evaluate the results of a previous judgement or service performed
4. Intimidation occurs when the professional accountant or firm is put under pressure by a client to act in a favourable manner ie, that is not objective.
5. Familiarity is the threat that a professional accountant will lose their objectivity towards a client because they are too close to that client.
6. A safeguard is any action or practice that helps to mitigate an ethical threat. They exist at a profession and firm-wide level.

You have now reached the end of this module. Press the 'Exit' button to close this window.

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