ETHICAL THREATS AND SAFEGUARDS

Ethical conflict

An ethical conflict (also known as an ethical dilemma) is when two ethical principles demand opposite results in the same situation. In order to resolve the conflict a choice must be made that by definition will leave at least one of the ethical principles compromised.

A key reason behind many ethical conflicts is a conflict of interest between taking decisions in one's own self-interest versus making decisions in the best interest of a client. For example an auditor has a moral obligation to earn money to feed, clothe and house his family. To purely satisfy this obligation they may take decisions that are not in the best interest of a client – for example reducing the extent of audit work and using more junior staff to save money on costs and generate bigger profits for the audit firm. However, the reduction in audit work and use of more junior staff would mean that the auditor has not complied with audit standards nor delivered the statutory audit that the client has paid for.

An ethical conflict may arise with confidential information that an accountant encounters, for example on the discovery of a fraud. The defrauded party (which may for example be the client company, an employee, a supplier, the shareholders or perhaps a bank) has suffered in some way and the auditor is aware of this. The auditor's primary responsibility is to provide an opinion on whether the financial statements provide a true and fair view not to report fraud to the plaintiff - it is normally the choice of the company how to proceed (unless crimes such as terrorism or money laundering are involved).

With both of the above examples numerous different courses of action could be justified using the theories you have encountered previously. However, professional codes of ethics are employed in the accountancy profession in order to establish consistent behaviour and a robust ethical conflict resolution process.

Rules-based and principles-based approaches to ethical conflicts

When accountants are faced with an ethical conflict they need to know what to do. If there is a threat to their compliance with the fundamental principles of the ethical code, how should they ensure their compliance and deal with the threat?

There are two possible approaches that the professional accountancy bodies could take, a rules-based approach and a principles-based approach.

i. A rules-based approach is to identify each possible ethical problem or ethical dilemma that could arise in the work of an accountant, and specify what the accountant must do in each situation.
ii. A principles-based approach is to specify the principles that should be applied when trying to resolve an ethical problem, offer some general guidelines, but leave it to the judgement of the accountant to apply the principles sensibly in each particular situation.

The IESBA (IFAC) Code (and other codes of accountancy ethics, including the ICAN Code) takes a principles-based approach, with some guidelines. The main reason for taking a principles-based approach is that it is impossible to identify every ethical dilemma that accountants might face, with differing circumstances in each case. Since it is impossible to identify every problem that might arise, rules could only be provided for some problems but not others.

The IESBA (IFAC) Code makes this point, saying that it is exceedingly difficult to predict all situations that create threats to compliant with the fundamental principles and the suitable course of action. Threats needing different safeguards may exist depending on the work assignment or engagement. It is in the public interest, therefore, to have a conceptual framework for the accountants to follow, rather than a set of strict rules. It is interesting to note that IESBA (IFAC) considers the public interest when choosing a principles-based approach in preference to a rules-based approach.

The nature of a principles-based approach

The recommended approach to resolving ethical problems, which will be considered in more detail later, is based on the following steps:

i. **Identify threats** to compliance with the fundamental principles. Accountants have an obligation to identify any threat to their compliance with the fundamental principles, when it could reasonably be expected that they should be able to identify it.
ii. **Evaluate the threat**: Qualitative factors as well as quantitative factors should be considered in the assessment of a threat to compliance. Insignificant threats may be ignored but others should be dealt with.
iii. **Respond to the threat**: If it is 'not insignificant', the accountant should apply appropriate safeguards, if he can, to eliminate the threat or reduce the threat to an insignificant level.
iv. **Take action**: If suitable safeguards cannot be applied, more drastic action will be needed, such as refusing to carry out a professional service, ending the relationship with a client or resigning from the job.

Nature of ethical threats

Threats to compliance with the fundamental ethical principles are grouped into five broad categories:

a. Self-interest threats, or conflicts of interest: These occur when the personal interests of the professional accountant, or a close family member, are (or could be) affected by the accountant's decisions or actions.
b. Self-review threats: This type of threat occurs when a professional accountant is responsible for reviewing some work or a judgement that he was responsible for originally. An extreme example would be a situation where a professional accountant prepares the annual financial statements for a corporate client and then is appointed to do the audit.
c. Advocacy threats: This type of threat can occur when an accountant promotes the point of view of a client, for example by acting as a professional witness in a legal dispute. Acting as an advocate for the client can reach the point where the objectivity of the accountant is compromised.
d. Familiarity threats: A familiarity threat arises from knowing someone very well, possibly through a long association in business. The risk is that an accountant might become too

familiar with a client and therefore becomes more sympathetic to the client and more willing to accept the client's point of view.

e. **Intimidation threats**: A professional accountant might find that his objectivity and independence is threatened by intimidation, either real or imagined.

These threats to compliance with the fundamental ethical principles apply to firms of accountants in their dealings with clients as well as to individual accountants.

Nature of ethical safeguards

When there are threats to compliance with the fundamental ethical principles, the accountant should assess the safeguards against the threat. There might already be safeguards in place that eliminate the possibility that the risk will ever materialise, or that reduce the risk to an acceptable level. If the safeguards that exist are not sufficient, the accountant should try to introduce new safeguards to eliminate or reduce the risk to an insignificant level.

Ethical safeguards can be grouped into two broad categories:

i. Safeguards created externally, by legislation, regulation or the accountancy profession

ii. Safeguards established within the work environment.

Safeguards created by legislation, regulation or the accountancy profession

Safeguards that are created externally, by legislation, regulation or the profession, include the following.

a. The requirements for individuals to have education and training and work experience, as a pre-condition for membership of the professional body.

b. The continuing professional development (CPD) requirements for qualified members, to ensure that they maintain a suitable level of competence.

c. Corporate governance regulations, particularly those relating to auditing, financial reporting and internal control.

d. Professional standards, such as financial reporting standards and auditing standards. □ Monitoring procedures and disciplinary procedures.

e. External review by a legally-empowered third party.

Safeguards in the work environment

A variety of safeguards can be applied within the work environment. These can be categorised into:

a. Safeguards that apply across the entire firm or company: these include

i. a code of ethics for the company or firm and suitable ethical leadership from senior management

ii. a sound system of internal control, with strong internal controls

iii. the application of appropriate policies and procedures for monitoring the quality of work done for clients

iv. Policies that limit the reliance of the firm on the fee income from a single client.

b. Safeguards that are specific to a particular item of work: These include

i. keeping individuals away from work where there might be a threat to their compliance with the fundamental principles (for example where a conflict of interests or a conflict of familiarity might exist)
ii. in the case of audit firms, rotating the audit partner so that the same audit partner is not responsible for the audit of the same client company for more than a specified maximum number of years
iii. the application of strong internal controls
iv. using another accountant to review the work that has been done by a colleague
v. Discussing ethical issues with those people in the company who are responsible for governance issues, such as the audit committee, senior non-executive director, or board of directors.

Example 1: Inheritance
A member of the audit team working on the audit of ABC Company has just received an inheritance that includes a large number of ABC Company shares. What is the ethical risk and what safeguards against the risk might be appropriate?

Answer: The risk is that the member of the audit team has a financial interest in the client, by owning a large number of the client company shares. There is a potential conflict of interest, which will threaten his or her integrity. Suitable safeguards would be either to persuade the individual to sell the shares, or to remove the individual from the audit of ABC Company.

Example 2: Partner and director
A senior partner in an audit firm is also a director of XYZ Company. XYZ Company has approached the audit firm, and asked it to become the company's auditors. What is the ethical risk and what safeguards against the risk might be appropriate?

Answer: The risk is that the senior partner has a financial interest in the client company, and presumably also has a familiarity risk. The IESBA (IFAC) Code and ICAN Code state that in this situation, there are no safeguards that are strong enough to reduce the threat from the conflict of interest to an insignificant level. The firm must refuse to take on the audit work.

Example 3: Foreign parent
You are an accountant working in public practice in Nigeria. You are approached by a subsidiary company of a foreign parent company. This company would like you to provide a number of professional services. The parent company is based in a country where you have no professional contacts. What are the safeguards against the risk that should reduce the risk to an acceptable, insignificant level?

Answer: A key safeguard is to obtain information that verifies the ownership of the parent company and shows who has ultimate control over the group, including the Nigerian subsidiary. Before accepting the Nigerian subsidiary as a client, enquiries should be made in the country of the parent company. The enquiry might be made through an ICAN (or other reputable accountancy institute) member in that country or an ICAN member might be asked to recommend a local lawyer who could do the work. You would want to receive certified copies of original documentation relating to the structure of the parent company, evidence of its registration as a company (including the details registered on its incorporation), a list of the members of its board of directors and any other information about the company that is available to the public in that country. If you are satisfied with the information you receive, you should feel able to take on the subsidiary company as a client. If you are not satisfied, and are unable to obtain any other information that provides the safeguards you are looking for, you should inform the company that you are not able to provide the services that the company requires.