

Ethics Resources  
for Accounting Professionals

# EXTERNAL AUDITORS

The primary role of external auditors is to express an opinion on whether an entity's financial statements give a true and fair view or are presented fairly, in all material aspects, in accordance with an applicable financial reporting framework. External auditors must exercise professional judgment and remain objective in the audit process. In order to uphold their independence and objectivity, it is essential that external auditors stay vigilant to potential ethical dilemmas.



# ETHICAL SCENARIOS



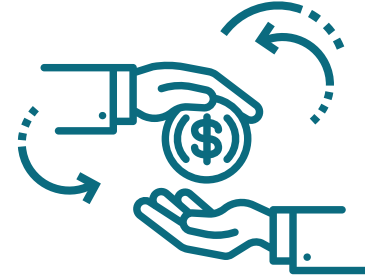
## Acceptance of advantages and entertainment

Is it fine for me to accept meals, entertainment, gifts, employment contract, etc. from my clients?



It is not uncommon for clients to treat external auditors to meals and other entertainment during the course of an audit to get acquainted with them, or offer gifts to the auditors as a token of thanks after their hard work.

Some clients may even offer competitive employment contracts to their external auditors, especially the seasoned ones who have become conversant with their clients' business operations and financial positions after years of audit service. A considerable bonus would often be given if the auditors join the companies at a particular time.



## Suspicious transactions identified during audit

The transactions look suspicious. Should I turn a blind eye to them?



During audits, external auditors may come across suspicious transactions which involve large sums of money or unusual patterns of activity. The transactions seem to have no apparent economic purpose though no irregularity is identified at the time. Despite requests for clarification, the client refuses to provide the required information and no reasonable explanation is given.

When handling the above situations, external auditors should remain vigilant to the legal requirements under the **Prevention of Bribery Ordinance (POBO) (Cap. 201)** and other relevant legislations, as well as the various threats to the **fundamental principles of ethics for professional accountants**.



## PREVENTION OF BRIBERY ORDINANCE

According to Section 9 of the Prevention of Bribery Ordinance (POBO), an agent (e.g. an employee, a partner), without the permission of his/her principal (e.g. the employer, the company, all partners of a firm) or any reasonable excuse, solicits or accepts any advantage for doing or forbearing to do any act in relation to his/her principal's affairs or business, shall be guilty of an offence.

Advantage refers to anything that is of value such as money, gift, commission, loan, employment, service or favour, except entertainment. Entertainment refers to the provision of food or drink for consumption on the occasion when it is provided, and any other entertainment connected with such provisions.

## CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

### Fundamental principles of ethics for professional accountants

According to the Code of Ethics for Professional Accountants (COE) issued by the HKICPA, there are five fundamental principles of ethics for professional accountants (the fundamental principles):

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

### Inducements, including gifts and hospitality

Under section 340 of Chapter A of the COE, an inducement is an object, situation, or action that is used as a means to influence another individual's behaviour, but not necessarily with the intent to improperly influence that individual's behaviour. Inducements can range from minor acts of hospitality between professional accountants and existing or prospective clients to acts that result in non-compliance with laws and regulations. An inducement can take many different forms, for example, gifts, hospitality, entertainment, employment or other commercial opportunities, etc.

A professional accountant shall not accept or encourage others to accept any inducement that is made with the intent to improperly influence the behaviour of the recipient or of another individual. An inducement is considered as "improper" if it causes the individual to act in an unethical manner. The fundamental principles are an appropriate frame of reference for a professional accountant in considering what constitutes unethical behaviour. However, if such an inducement is trivial and inconsequential, any threats created will be at an acceptable level.



## KEY ISSUES AND TAKEAWAYS

### Acceptance of advantages and entertainment

An external auditor may commit an offence under Section 9 of the POBO if he/she, without the principal's permission, accepts an advantage (e.g. gifts, employment) from the client as a reward or an inducement for him/her to favour the client during the audit process. Acceptance of illicit advantages for turning a blind eye to the exceptions identified, for reducing the sample size for vouching without any justification, or for freezing the audit fee will constitute a breach of the POBO.

Under certain circumstances (e.g. during festive seasons), a principal may allow an agent to accept advantages (e.g. some gifts or souvenirs) on a case by case basis. Nevertheless, external auditors should always be mindful not to conduct any acts contravening the COE.

Although entertainment is an acceptable form of business and social behaviour, an external auditor should avoid lavish or frequent entertainment from persons with whom his/her firm has business dealing (e.g. audit clients). This is to avoid placing himself/herself in a position of obligation or involving in a potential conflict of interest situation where self-interest, familiarity and even intimidation threats may be created. The acceptance of advantages and entertainment, while in some cases, not prohibited by laws and regulations, might still create threats to compliance with the fundamental principles. Before accepting an advantage or entertainment, an external auditor should evaluate the level of threats, consider the appropriate actions and safeguards including discussion and/or obtaining approval from the principal.

### Suspicious transactions identified during audit

External auditors are bound by the COE to conduct themselves according to the fundamental principles and to act in the public interest, not only the interests of their clients. Furthermore, it is the statutory duty for anyone in Hong Kong, including accountants, to report suspicious transaction to a law enforcement agency where there is a genuine knowledge or suspicion of money laundering or terrorist financing.

Despite the long-term or close relationship with a client, when an external auditor identifies transactions which are complex, involve unusually large sums of money or unusual patterns of activity, and have no apparent economic purpose, he/she must examine the background and purpose, including the circumstances of the transactions where appropriate. The findings of these examinations must be properly documented in writing. Proper records detailing the auditor's understanding of the matter, audit evidence obtained and the auditor's conclusion will help to demonstrate that an auditor has exercised professional scepticism and complied with the fundamental principles.

Section 360 of Chapter A of the COE provides a response framework for when professional accountants in public practice become aware of information concerning non-compliance or suspected non-compliance in the course of performing an audit engagement. External auditors should also refer to Chapter F of the COE for guidelines on anti-money laundering and counter-terrorist financing for professional accountants.

# 🔍 CASE STUDY

## INDEPENDENCE AND PROFESSIONAL INTEGRITY



**1** Wendy and Mandy were close friends at university. After graduation, Wendy started her own retail company, WW Co. Ltd., which had been expanding very fast and reporting a high annual turnover.



**2** Mandy pursued a career in accountancy and became a partner in a CPA firm. WW Co. Ltd. became one of the major accounts of Mandy's firm, contributing 25% of its revenue.



**3** This year, WW Co. Ltd. was facing a very difficult position. Apart from losing a few major customers, a significant loss was discovered after Mandy's firm completed the year-end audit.



**4** Besides, during the audit some unusual transactions were identified which involved unnecessary complexity and which did not constitute the most logical or secured way to do business.

Wendy failed to provide information regarding the transactions upon Mandy's request.

 **CASE STUDY** (CONTINUED)

**INDEPENDENCE AND PROFESSIONAL INTEGRITY**



**5** Although the company had faced a challenging year, Wendy told Mandy that she was negotiating a big order.

If she could successfully apply for a line of credit with a bank to handle the order, WW Co. Ltd.'s position would turn around.



**6** However, Wendy was worried that the bank would not grant credit facilities to WW Co. Ltd. in view of its current financial position.

Wendy suggested that Mandy should use whatever device she could to improve the reported financial position of WW Co. Ltd.



**7** Wendy promised Mandy that she would be "rewarded" afterwards.

But if Mandy refused her request, she had no choice but to appoint another CPA firm next year.



**WHAT SHOULD MANDY DO?**

## COMMENTARIES ON THE CASE



Mandy should make it clear to Wendy that although they were close friends and WW Co. Ltd. was an important client of her firm, no financial inducement or veiled threat would cause her to compromise her **independence** and **professional integrity**.



Mandy should explain to Wendy that it was inappropriate to use any “device she could to improve the financial position” and assure Wendy that she and her firm would try their best to help WW Co. Ltd. achieve its legitimate business objectives and work together to meet the challenges.



Mandy should refuse Wendy’s offer of a “reward” and report it to the ICAC. Being offered an advantage for her misrepresentation of the financial position of WW Co. Ltd. was a breach of **Section 9 of the POBO**.

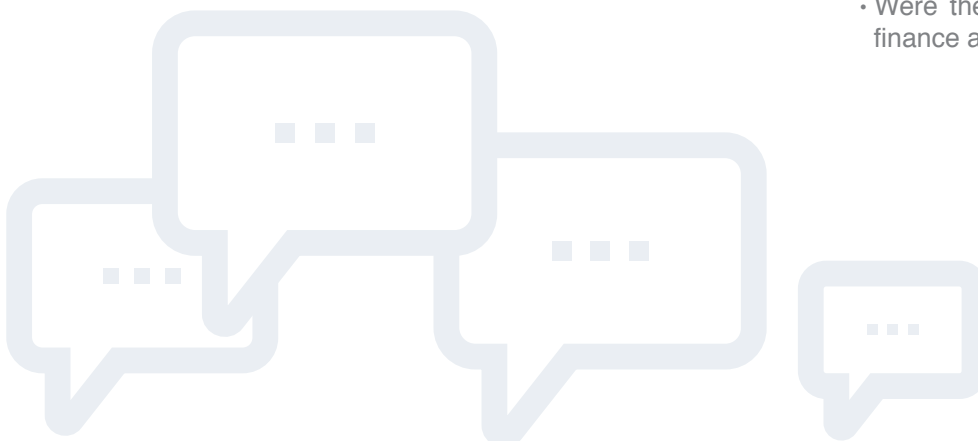


Mandy should first seek to ascertain whether Wendy’s concerns about applying for credit facilities from banks are well-founded. They should consider questions such as:

- Had the bank ever been approached and given any indication of the terms and conditions for making credit facilities available to WW Co. Ltd.?
- How weak was WW Co. Ltd.’s financial position? Did the company have any fixed assets which could be offered as security for the new credit facilities? Would any related parties be prepared to guarantee the credit facilities on behalf of the company?
- Did the company’s financial forecasts indicate that, on an ongoing basis, and assuming the contract was won, the required credit facilities could be serviced and what cover was implied?
- Were there any other sources of finance available to WW Co. Ltd.?



Being mindful at all times of the need to **preserve client’s confidentiality**, Mandy might consult her fellow partners in considering alternative responses to this sensitive situation and clarifying her own personal responsibilities in the circumstances. In the event that there was no appropriate internal channel within her firm to facilitate this consultation, Mandy might consider seeking legal advice.



## COMMENTARIES ON THE CASE (CONTINUED)



Mandy should explain to Wendy that with a well prepared case, the bank might well place greater reliance on WW Co. Ltd.'s forecast profitability and cash flows rather than on historical financial information, particularly if Wendy's belief that the company's position "would turn around" was a reasonable assessment. If financial forecasts were not available, Mandy could suggest WW Co. Ltd. to seek assistance from relevant professional service provider in preparing the forecasts and a proposal for credit facility to the bank. If Mandy's firm is engaged in reporting on WW Co. Ltd.'s financial forecasts, it should observe relevant **independence** and **ethical requirements** before accepting the engagement.



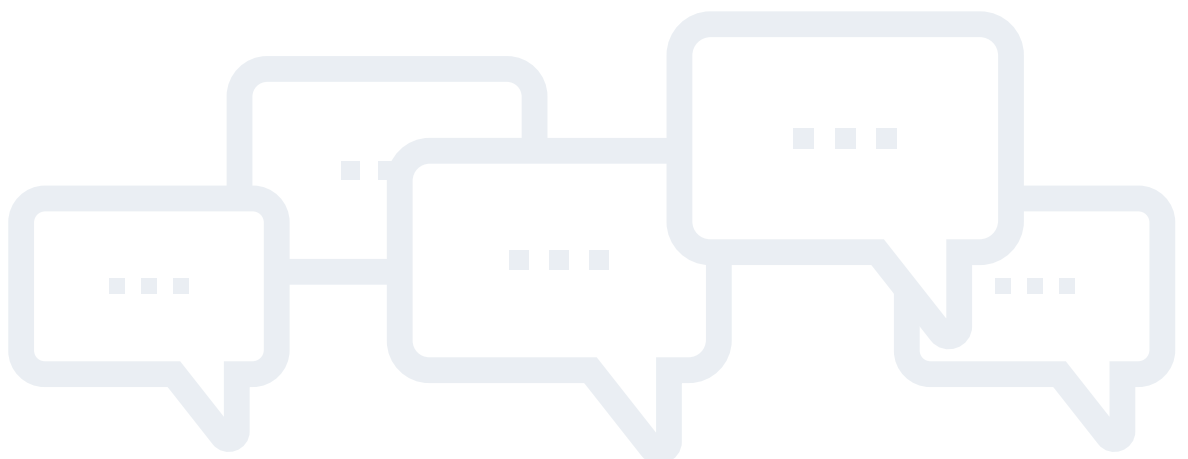
If Wendy was unwilling to change her position, Mandy should explain to her that a modified auditor's report would be issued if the audit team concluded – or was unable to obtain sufficient appropriate audit evidence to conclude – that WW Co. Ltd.'s financial statements as a whole were not free from material misstatement.



In the auditor's report, Mandy should describe the matter giving rise to the modified auditor's opinion in accordance with the relevant standard and requirement. To fulfil her statutory duty and requirement under the COE, Mandy should **report suspicious transactions** identified during audit to the Joint Financial Intelligence Unit.



Having fulfilled the statutory responsibility by reporting to the shareholders and relevant authorities, Mandy should consider whether withdrawal from the audit engagement of WW Co. Ltd. is necessary in light of the identified or suspected non-compliance. Upon resignation, Mandy should consider any **professional and legal responsibilities** to report on the reasons of withdrawal. For example, the Companies Ordinance (Cap. 622) requires the auditor to give a statement to the company on circumstances connected with the withdrawal that should be brought to the attention of the company's members or creditors.





## COMMENTARIES ON THE CASE (CONTINUED)



In all circumstances, however, Wendy's actions in the face of WW Co. Ltd.'s current difficulties had seriously undermined her integrity. Mandy should retain a heightened degree of professional scepticism in all future dealings with Wendy and WW Co. Ltd., including reassessing the engagement risk associated with the decision to continue to serve this client.



**Audit Fee** - As the total fees from WW Co. Ltd. represented a significant proportion of the total fees of Mandy's firm or a significant proportion of the revenue from Mandy's clients, the dependence on WW Co. Ltd. and concern about losing WW Co. Ltd. created self-interest or intimidation threat. Safeguards should be applied to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards may include:

- reducing the fee dependency on WW Co. Ltd.;
- having a professional accountant who did not take part in the audit engagement to review the work; or
- regular independent internal or external quality reviews of the engagement.



**Conflict of Interest** - Conflict of interest situations might arise as Wendy and Mandy were close friends and WW Co. Ltd. was one of the major clients of Mandy's firm. Professional accountants should identify and evaluate the threats and relationships that might create a conflict of interest and implement safeguards, when necessary, to eliminate or reduce the threats to compliance with the fundamental principles to an acceptable level. For more information about the ways to handle conflict of interest situations and the possible consequences arising from the mishandling of conflict of interest, please refer to the "Topic of Interest" section in the article for "Financial Accountants".





## TOPIC OF INTEREST

### ANTI-MONEY LAUNDERING (AML) AND COUNTER-TERRORIST FINANCING (CTF)

The amended Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), effective from 1 March 2018, extends the scope to cover “designated non-financial businesses and professions”, including **accountants**. Accountants in practice should comply with the existing legal requirements on AML/CTF, observe the relevant guidelines under the COE and adopt appropriate measures when preparing or carrying out for a client a transaction concerning services of higher risks, e.g. buying and selling of real estate/business entities, managing of client money, securities or other assets. Practices and members working in practices must have in place internal policies, procedures and other controls which cover primarily the following areas:

#### Risk assessment and management

Adopt a risk-based approach which can identify and categorise money laundering/terrorist financing overall risks at the client level and establish reasonable measures based on the risks identified, and have adequate management oversight in relation to AML/CTF.

#### Suspicious transactions reporting

Make a report to the appropriate law enforcement agency (e.g. the Joint Financial Intelligence Unit) as soon as possible after the suspicion or knowledge is first established.

#### Staff hiring and training

Ensure adequate standards when hiring employees, and provide appropriate AML/CTF training to the staff.

#### Customer due diligence

Identify the client or beneficial owner in relation to the client, and verify the identity using documents, data or information provided by a government body or other reliable, independent source.

#### Record keeping

Prepare, maintain and retain documentation and records on practices’ business relations with, and transactions for, clients, as are necessary and sufficient to fulfil legal or regulatory requirements, and which are appropriate to the scale, nature and complexity of their businesses.

#### Ongoing monitoring

Update from time to time documents, data and information relating to the client; pay attention to transactions carried out for the client to ensure that they are consistent with the client’s nature of business, risk profile and source of funds.

#### Compliance management

Designate a Money Laundering Reporting Officer at the management level.

**For more details, please refer to Chapter F of the COE.**

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