# AUDITING (AUD)
CPALE Concept Notes

# CODE OF ETHICS – PH CPAs
Source: REO Live (Sir George), Pre-Recorded (Sir Escala), and CPAR Lecture (Sir G. Roque)

***Topics Covered:***
*2. Auditing Practice*
*2.1. Governance, Ethics, and Quality Management*
*2.1.1. Corporate governance*
*2.1.2. Ethical standards and responsibilities of professional accountants*

***Preliminaries***

### Major Characteristics of a Profession
- Mastery of a particular intellectual skill
- Acceptance of duty or responsibility to the public
- Code of ethics (conduct)

### Process of Approval of the Code or any Standard

**Discussion Papers within Working Groups**
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**Exposure Drafts**

<u>AASC</u>
- Majority vote
- 90 exposure days

<u>FSRSC</u>
- Majority vote
- 60 exposure days (30 days if urgent)

↓
**General Public**
*(for Comments, Suggestions, Recommendations)*
↓
**Final Draft**

<u>AASC</u>
- At least 10 votes

<u>FSRSC</u>
- Majority vote

↓
**BOA** *(for Approval)*

### *THE CODE OF ETHICS OF PROFESSIONAL ACCOUNTANTS*
- Applies to all professional accountants (CPAs)
- ***Approved by BOA; Recommended for Adoption by PICPA***
- Published for the purpose of reflecting accountants' <u>*recognition of its public interest (collective well-being) responsibility*</u>
- Provides guidance and basic principles, but ***still subject to the professional accountant's decision***
- ***4 Parts*** *(5 if including the Glossary)*
  - Part 1: Conceptual Framework
  - Part 2: Professional Accountants in Business (PAIB)
  - Part 3: Professional Accountants in Public Practice (PAPP)
  - Part 4: International Independence Standards
    - *4A: Independence Standards for Audit and Review*
    - *4B: Independence Standards for Other Assurance Engagements*

***Part 1: Conceptual Framework***
- Sets how to use the Code
- Applies to all professional accountants
- If <u>*conflicting with laws*</u>, ***national laws will prevail***
- If there are <u>*conflicting requirements of the Code between two countries*</u>, ***the Code with a STRICTER provision shall be applied***

### *FUNDAMENTAL PRINCIPLES "PICOP"*

1. ***<u>P</u>rofessional Competence and Due Care***
   - To *attain (Stage 1)* and *maintain (Stage 2)* <u>*professional knowledge and skills required*</u> to render a competent professional service
   - To <u>*act diligently and in accordance*</u> with applicable standards

   <u>*General Rule:*</u>
   ***Do not accept an engagement if your competence is not enough***

   <u>*XPNs:*</u>
   - You ***will gain or acquire the necessary skill and knowledge***, *OR*
   - Consult or hire ***experts*** *(aside from accounting)*

2. ***<u>I</u>ntegrity***
   - <u>*Straightforward and honest*</u> in dealing with clients
   - ***Avoid association*** with <u>*recklessly prepared information*</u> and materially <u>*false or misleading statements*</u>

3. ***<u>C</u>onfidentiality***
   - Non-disclosure of engagement details without authorization <u>*even after the engagement or relationship*</u>

   <u>*XPNs (SRP):*</u>
   - <u>S</u>pecific authority *(acting with appropriate authority)*
   - <u>R</u>equired by law
   - <u>P</u>rofessional right or duty

4. ***<u>O</u>bjectivity***
   - ***Impartial and neutral***; <u>*without bias*</u> while performing the engagement
   - <u>*Not compromising judgments*</u> due to bias, conflict of interest, or undue influence of others

5. ***<u>P</u>rofessional Behavior***
   - Avoid any conduct that might <u>*discredit the profession*</u>
   - Act in a manner <u>*consistent with the profession's reputation*</u>
   - Comply with relevant laws
   - <u>*No exaggerated claims*</u> for offered services and qualifications or experiences
   - <u>*No disparaging references or unsubstantiated comparisons*</u> to the works of others

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### *Threats to Compliance with Fundamental Principles*
- Situations that might force you to violate the fundamental principles
- Safeguards must be in place to reduce such threats

  ***Safeguards*** – policies and procedures to eliminate or reduce threats at an acceptable level
  - May be <u>*engagement-specific*</u> *(per engagement basis)* or <u>*firm-wide*</u>
  - *Examples:*
    *EQR'er, rotation of members, prohibition on certain assignments*

1. ***Self-Interest Threat***
   - <u>*Financial or other interest (fees)*</u> inappropriately influencing judgment or behavior
     - Money
     - Employment
     - Career *(errors found and manipulation – blackmail)*

2. ***Self-Review Threat***
   - Inappropriate <u>*evaluation of results of previous judgments made*</u>
     - Providing ***non-assurance services to its assurance client***
     - ***Compiled and audited*** the same FS
     - Audited the FS prepared by ***own-made AIS***
     - ***Overlap of role*** as preparer or involved in making the FS and as an auditor
       *(ex.: Jan. – XYZ Co.'s Accountant; Year-end – Auditor of XYZ Co. for the Whole Year)*

3. ***Advocacy Threat***
   - Promotes <u>*client's interest or position*</u>, compromising objectivity
     - Both a ***legal counsel*** and the auditor
     - Both a ***promoter of client shares*** and the auditor

4. ***Familiarity Threat***
   - Boils down to <u>*undue influence*</u> that a client can invoke to the auditor
     - Being ***too sympathetic*** and accepting of client's work
     - ***Relatives and family members*** *(usually of high position)*

| | |
|---|---|
| *Having Significant Close Relationship* | ***Familiarity Threat*** |
| *Having Significant Close <u>Business</u> Relationship* | ***Self-Interest Threat*** |

- ***Mentor*** *(former partner mentor, became client's director)*

| | |
|---|---|
| *Previously an Engagement Partner* | ***Familiarity Threat*** |
| *Previously a Director/Officer of Client* | ***Self-Review Threat*** |

- ***Long or close relationship*** with a client

  *<u>Solution</u>: Rotation after 7 cumulative years*

| | |
|---|---|
| PIE Engagement Partner | ***5 years cooling-off period*** |
| PIE EQR'er | ***3 years cooling-off period*** |
| PIE Other KAP Role | ***2 years cooling-off period*** |
| PIE Mixed Roles | Follow cooling-off period of **MAJORITY role** |
| Non-PIE | ***Firm-determined periods*** |

5. ***Intimidation Threat***
   - ***Deterred from acting objectively due to pressures***
     - *Harm (physical, mental, etc.)*
     - *Dismissal*
     - *Litigation*
     - *Replacement*
     - *Fewer Scope to Lower Fee*

| | |
|---|---|
| *Client Invoked Fear or Threatened* | ***Intimidation Threat*** |
| *Own Fear of Losing the Client* | ***Self-Interest Threat*** |

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### *Three-Step Approach of Conceptual Framework*

- *<u>Step 1: Identify Threats</u>*
- *<u>Step 2: Evaluate the Threats</u>*
  - As to ***significance*** ***(reasonable and informed third party test)*** ***and likelihood*** of occurrence
- *<u>Step 3: Address the Threats</u>*
  *Either of the following, as the case may be:*
  - ***Eliminate circumstances*** creating the threat, or
  - Apply ***safeguards*** to reduce threat at an acceptable level, or
  - ***Decline*** (end) the engagement

### *Breach of the Code* *(Excluding Independence Standards)*

- Evaluate the significance and impact of the breach
- Take actions available to address consequences
- Determine whether to report the breach to relevant parties

### *Part 2: Professional Accountants in Business (PAIB)*

Applies to professional accountants in:

- Commerce and industry
- Academe or education
- Government
- Public practice as to activities ***pursuant to their relationship with the firm as employer, contractor, or owner***

### *Part 3: Professional Accountants in Public Practice (PAPP)*

Applies to professional accountants in:

- Public practice ***when providing Professional Services***

### *Part 4: International Independence Standards*

### *INDEPENDENCE*

- Not a fundamental principle, but *<u>grounded on integrity and objectivity</u>*
- Used and ***required in assurance engagements*** *<u>during the engagement period and period covered by the subject matter</u>* (FS)
- Independence of mind and of appearance are of ***EQUAL importance***

#### *<u>Independence of Mind (Fact)</u>*

- Ability to make ***rational decisions***
- Expression of conclusion is ***not affected by influences*** compromising professional judgment

#### *<u>Independence of Appearance</u>*

- ***Avoidance*** of facts or circumstances *<u>likely making a reasonable third party conclude a compromised integrity</u>*, objectivity, or professional skepticism

#### *Period When Independence is Required*

- From the *<u>start of the period of FS or the SMI</u>* until the *<u>audit or assurance report date</u>*

### *Part 4A: Independence Standards for Audit and Review*

#### *Breach of Independence Provisions*

- End, suspend, or eliminate the interest or relationship
- Comply with any legal or regulatory requirements and ***consider reporting to a professional or regulatory body as applicable***
- ***Promptly communicate*** the breach <u>to relevant parties</u>
- *<u>Evaluate</u>* the breach significance and its ***impact on firm's objectivity and its ability to issue an audit report***
- Determine whether to end the engagement or an action can be taken that satisfactorily addresses the consequences

### *Part 4B: Independence Standards for Other Assurance Engagements*

#### *Breach of Independence Provisions*

- End, suspend, or eliminate the interest or relationship
- Evaluate the breach significance and its impact on firm's objectivity and its ability to issue an assurance report
- Determine whether an action can be taken that satisfactorily addresses the consequences

### *Other Matters as to Independence and Threats*

#### *FINANCIAL INTEREST*

- *<u>Direct Financial Interest</u>*
  *Either of the following:*
  - If through ***employment***, or
  - If through ***personal ownership of shares***, including the professional accountant's *<u>immediate family</u>* *(spouse and dependent children)*
- *<u>Indirect Financial Interest</u>*
  - If through ***ownership of shares by parents, siblings, in-laws, cousins, or non-dependent children***

#### *Impairment of Independence*

| *Financial Interest* | *Materiality* | *Effect to Independence* | *Action Needed* |
|---|---|---|---|
| Direct | Regardless | Impairs Independence | Dispose ALL |
| Indirect | Material | Impairs Independence | Dispose All OR Just Enough to Make Remaining Interest as Immaterial |
| Indirect | Immaterial | Does not impair independence | N/A |

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#### *AUDIT FEES*

- Overdue (unpaid) for *<u>1 year</u>* – Okay to release report
- Overdue (unpaid) for *<u>2+ years</u>* – Do Not release report until only one year is unpaid
- However, *<u>retention of client records to enforce payment</u>* of overdue audit is ***not allowed as it is considered discreditable to the profession***

#### *<u>Contingent Fees</u>*

*(% of Adjusted Net Income, % of Loan Proceeds, Approval of Loan, Type of Report Opinion)*

- NOT ALLOWED for assurance engagements
- Allowed *<u>if with appropriate safeguards</u>* for non-assurance engagements
- Fees may be based on efforts, nature of service, actual time spent, prior auditor charges (or even lower), or fixed by court or public authority, among others., as long as ***not subject to condition***

## *LOANS AND GUARANTEES*

### *a. Auditor as Debtor, Client as Creditor*

1. *Loan with Banks (Financial Institutions)*

| ***Terms and Conditions*** | ***Materiality of Amount to the Auditor*** | ***Effect to Independence*** |
|---|---|---|
| Normal | Material | ***Impairs Independence*** *(Creating Self-Interest Threat)* |
| | Immaterial *(Assumed if silent under normal terms)* | ***Does not impair independence*** nor create self-interest threat |
| Special | Regardless | ***Impairs Independence*** *(Creating Self-Interest Threat)* |

2. *Loan with Non-Financial Institutions (Non-Banks)*

| ***Materiality of Amount*** | ***Repayment*** | ***Effect to Independence*** |
|---|---|---|
| Material | Regardless | ***Impairs Independence*** *(Creating Self-Interest Threat)* |
| Immaterial | Not Repaid Immediately | |
| | Repaid Immediately *(or offset to audit fees)* | ***Does not impair independence*** nor create self-interest threat |

### *b. Auditor as Creditor, Client as Debtor*

1. *Unpaid Fees*
   ***Impairs independence if more than 1 period is unpaid***
2. *As Depositor of Bank-Client (or Brokerage)*

| ***Terms and Conditions*** | ***Materiality of Amount to the Auditor*** | ***Effect to Independence*** |
|---|---|---|
| Normal | Material | ***Impairs Independence*** *(Creating Self-Interest Threat)* |
| | Immaterial *(Assumed if silent under normal terms)* | ***Does not impair independence*** nor create self-interest threat |
| Special | Regardless | ***Impairs Independence*** *(Creating Self-Interest Threat)* |

### *c. Guarantees*

*Generally, **IMPAIRS independence, unless if immaterial***

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## *COMMISSION OR REFERRAL FEES*

*General Rule:*

- ***Not allowed***, but the *auditor is allowed to request for compensation from client on any professional service rendered so far*

*XPN:*

- There are ***sufficient safeguards against self-interest threat*** *(Ex.: No control of the commission – choice of foundation)*

*In case violated, not only the receiver of commission violates, but BOTH CPAs.*

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## *BUSINESS RELATIONSHIPS*

- Creates *self-interest, familiarity, and intimidation* threat
- Generally, ***a significant threat with no safeguards*** to bring at an acceptably low level *(Just stop or end the engagement)*
- However, purchase of goods and services by auditor from a client generally DOES NOT create threat to independence if made in its ***ordinary course of business***

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## *GIFTS, HOSPITALITY, INDUCEMENTS*

- Only ***accept if trivial and inconsequential***
- Creates *self-interest, familiarity, and intimidation* threats
- Affects integrity, objectivity, and professional behavior

## *INVESTMENT OF AN AUDIT FIRM IN A MUTUAL FUND THAT INVESTS IN ORDINARY SHARES OF SOME OF ITS CLIENTS*

- If investment decisions lie on the *auditor*, the independence is ***impaired*** *(direct financial interest)*
- If investment decisions lie on the *fund manager*, the independence is ***not impaired***

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## *PROFESSIONAL ACCOUNTANTS' MARKETING AND PUBLICITY*

- Advertising and publicity are *generally acceptable*, ***subject to certain restrictions due to possible self-interest threats***
- Must be *honest and truthful* when marketing professional services
- ***No exaggerated claims*** for services, qualifications, or experiences
- If seeking employment or professional business, *may write a letter or make a direct approach* to another professional accountant
- *Genuine vacancies* for staff ***may be communicated to the public through any comparable medium***
- Publications *specifically directed to schools* and places of education ***may be described in a business-like way***
- Professional accountants are ***not prevented from providing training services*** to other people
- Professional accountants in public practice are ***not allowed*** to:
  - *Refer, use, or cite testimonials by third parties*
  - *Publish services in billboard advertisements*
  - *Publish and compare fees with other CPAs or CPA firms*
  - *Compare services with those provided by another firms or CPA practitioner*