

F1

Financial Reporting and Taxation

Now that you have a reasonable grasp of CIMA's fundamental ethical principles and the threats to these, it's time to consider the safeguards and practise how to respond when presented with an ethical conflict

By Rachel Tattersall

This article follows on from my introduction to CIMA's code of ethics, which was published in the September edition of the FM app. You would be well advised to read that before attempting to answer the following ethical questions from two past F1 exams, to which I'll provide model solutions. Note that each suggested answer will contain a considerable amount of extra information to aid your understanding.

Question 2(f) from September 2011

WZ is an assistant accountant with ABC. On 31 March 2011 ABC decided to sell a property. This was correctly classified as held for sale in accordance with IFRS 5, "Non-current assets held for sale and discontinued operations". In its draft financial statements ABC has written down the property by \$3.4m. The writedown was charged to the income statement for the year ended 31 August 2011. The draft financial statements showed a loss of \$1.3m for the year to 31 August 2011. When the management board of ABC reviewed the draft financial statements, it was unhappy that the draft statements showed a loss and decided that the property should continue to be shown under non-current assets at its previous carrying value.

You are required to: (a) explain the ethical problems that WZ faces; and (b) identify his possible options. Your answer should refer to CIMA's code of ethics (*five marks*).

Model answer

To recap, IFRS 5, "Non-current assets held for sale and discontinued operations", allows for a non-current asset to be classified as "held for sale", providing that the following conditions are satisfied:

- The assets must be available to be sold immediately in their present condition.
- Their sale must be highly probable.
- The sale must be expected to be completed within a year of the asset's classification as "held for sale".
- The assets must be actively marketed.
- The price of the assets must be reasonable in relation to their fair value.
- Actions required to complete the sale must have been made and it must also be unlikely that this plan will change significantly or be withdrawn.

(a) WZ seems to be in a position where his integrity and objectivity may be compromised. The principle of integrity imposes an obligation on professional accountants to be truthful and honest. An accountant should therefore not let themselves be associated with information that he or she believes to contain misleading statements. Continuing to show the non-current asset

at its previous carrying value could mislead stakeholders. WZ believes that the revised financial statements would not follow IFRS 5 and so not provide a true and fair view of the actual situation.

The principle of objectivity means that professional accountants should not allow a conflict of interest or the undue influence of others to override or compromise their professional and/or business judgment. The management board is overriding WZ's professional judgment by imposing its own business judgment.

If WZ were to accept the change, stakeholders might interpret this as a lack of professional judgment, which could bring his reputation – and that of the whole profession – into disrepute.

(b) In this situation WZ could consider the following possible options:

- Trying to persuade the management board that IFRS 5 needs to be followed and that the property must be treated correctly in the financial statements.
- If this argument is not accepted, refusing to remain associated with the financial statements, distancing himself from these as much as possible.
- Reporting the situation to the external auditors or other appropriate authorities, possibly after taking legal advice.
- Resigning from his post.

Numerous ethical safeguards could be applied, but the most appropriate ones to choose would depend on the particular circumstances of each case and the nature of the threat concerned. CIMA's code of ethics suggests that these can be categorised into two groups:

- Safeguards created by professional bodies, legislators and regulators. These include: the education and experience criteria for entering the profession; the duty to engage in CPD; professional standards; regulations such as the UK corporate governance code issued by the Financial Reporting Council; regulatory monitoring and disciplinary procedures; and external reviews by a third party.
- Internal safeguards established in the workplace. These include: policies and procedures to establish and monitor the quality of engagements (including those that can identify significant relationships, self-interest and reliance on revenue); the nomination of a senior manager to oversee the effectiveness of the quality-control system; and a culture of compliance with the fundamental ethical principles.

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There are numerous safeguards that accounting firms may require for a particular engagement in order to minimise threats to the fundamental ethical principles to an acceptable level. If this cannot be achieved, the engagement should not be accepted. Examples of engagement-specific safeguards include:

- Rotating senior members of the assurance team on the engagement in order to minimise the threat of familiarity.
- Involving another firm to complete part of the work or perform the whole engagement again.
- Consulting an independent third party, such as a committee of independent directors, a regulatory body or another professional accountant.

In the event of an ethical conflict, professional accountants need to work through a resolution process, taking account of the following elements:

- The facts relevant to the situation.
- The ethical issues involved.

- The applicable fundamental principles.
- The established internal procedures.
- Any alternative courses of action that could be taken.

Having considered all of the above, the accountant should be able to decide on a course of action that will uphold the fundamental principles.

Let's try another past question to apply the conflict-resolution process.

Question 2(b) from May 2013

Ace is a management accountant working as part of a small team that has been set up by ZY, his employer, to evaluate tenders submitted for contracts being awarded by ZY.

Ace has just discovered that one of the other team members accepted large payments in exchange for information from an entity at the time it was considering tendering. He suspects that this may have influenced the winning tender submitted by that entity.

You are required to explain the steps that Ace could follow to ensure that he adheres to CIMA's code of ethics for professional accountants (*five marks*).

Model answer

Ace needs to consider each of the following elements, keeping a written record of the steps he takes:

- The relevant facts. He must ensure that he gathers as much information pertaining to the issue as possible.
- The ethical issues involved. Based on the information he has gathered, Ace needs to decide whether there is a problem. The evidence indicates that a member of his team received a large payment in exchange for information, which implies that his independence may have been compromised. When that individual evaluated the contracts, he may have been biased in favour of the entity that paid him.
- The fundamental principles applicable. The most relevant principle at risk here is objectivity, as there is a self-interest threat to the professional judgment applied by Ace's colleague. In accepting a large payment in exchange for information, he has evidently prioritised his own interest in gaining more money over the interests of maintaining independence. If he has built a close relationship with the entity, there may also be a familiarity threat.
- The established internal procedures. Accountancy firms usually have a whistleblowing procedure and/or a grievance procedure. If one or other applies in this case, Ace should follow it.

- Any alternative courses of action that could be taken. Ace could raise his concerns internally with the team's manager. If this is unfeasible – for instance, if the manager is the individual who accepted the payment – Ace should speak to that person's manager or a board director. If no action is taken internally, Ace should take his concerns further by reporting his colleague to the relevant professional body. He could also distance himself from the problem by asking to be transferred to a different team or department.

For further practice tackling ethical issues from past F1 exams, try answering questions 2(f) from November 2011, 2(f) from March 2012, 2(b) from August 2013 and 2(c) from November 2014.

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