Three Chartered Accountants Involved in Fraud at Livent

The fraud occurred from 1996 to 1998, according to the lawsuits filed, and the three chartered accountants were all suspended in 2000. The January 2001 issue of Checkmark (a publication for chartered accountants from the Institute of Chartered Accountants of Ontario) explained that the “decision to suspend rather than expel was based on the fact that they played a substantial and personally costly role in disclosing the fraud at Livent to the new management and to the public.”

Livent Inc. was a Toronto-based entertainment company that went public in 1993. Livent produced Broadway musicals like Ragtime, Show Boat, and Kiss of the Spider Woman. The company had borrowed heavily in the years since going public to build theatres in Vancouver, New York, and Chicago. The founder, Garth Drabinsky, was fired in August 1998 amongst suits and counter suits that occurred around the same time as Livent’s financial statements were restated for 1996, 1997 and 1998. These statements reduced net income for 1996 to 1998 by $61.7 million.

Checkmark states that the chartered accountants were guilty of one or more of the following offences:

- signing statement(s) which were known to be false and misleading
- associating with ongoing and material accounting irregularities, including the fraudulent manipulation of the books and records
- signing a United States Securities and Exchange Commission registration statement knowing that the financial statements attached were false and misleading
- at the direction of management, misstating accounts to capitalize show production costs and transferring costs of shows to the capital costs of a theatre
- preparing schedules for management to review the effect of accounting manipulations

Thorough study of this chapter will enable you to:

3-1 Distinguish ethical behaviour from unethical behaviour in personal, professional, and business contexts (pages 58–61).

3-2 Identify ethical dilemmas and describe how they can be addressed (pages 61–64).

3-3 Describe the ethical concerns specific to the accounting profession (pages 64–66).

3-4 Explain the purpose and general content of a typical professional accounting code of ethics (pages 66–68).

3-5 Discuss independence as it applies to a public accountant (pages 68–73).

3-6 Discuss confidentiality as it applies to a public accountant (pages 73–74).

3-7 Discuss the standard of behaviour required of a public accountant (page 74).

3-8 Discuss integrity and due care as they apply to a public accountant (pages 74–75).

3-9 Discuss the responsibility of a public accountant to maintain professional competence (page 75).

3-10 Discuss the responsibility of a public accountant neither to associate himself or herself with false or misleading information nor to fail to reveal material omissions from the financial statements, but rather to comply with the standards of practice incorporated in the Recommendations of the CICA Handbooks (pages 75–76).

3-11 Discuss advertising and solicitation from the perspective of a public accountant (page 76).

3-12 Discuss other rules of conduct, including those dealing with contingent fees and with reporting breaches of the rules (pages 76–77).

3-13 Describe the enforcement mechanisms for the rules of conduct (pages 77–78).
What must it be like? Employed by a company, participating in apparently innocent accounting changes that become larger and larger, until suddenly you are in the middle of a multimillion dollar fraud. The time to ask questions is right away, when that first unexplainable entry is requested. Think of all the investors that lost their money. Perhaps it could have been prevented.


Ethics is a topic that is receiving a great deal of attention throughout our society today. This attention is an indication of both the importance of ethical behaviour in maintaining a civil society, and a significant number of notable instances of unethical behaviour. The authors believe that ethical behaviour is the backbone of the practice of public accounting and deserving of serious study by all accounting students. This chapter is intended to motivate such study. It begins with a definition and discussion of ethics at a general level, continues with a consideration of ethical dilemmas and how they can be approached, and ends with a discussion of ethics in the accounting profession focused on certain of the more important rules of conduct of chartered accountants and certified general accountants, who make up the bulk of practising public accountants in Canada.

While certain of the rules to be discussed, such as integrity and due care, are common to CAs, CGAs, CMAs, and other professionals, others, such as independence, relate more to public accountants performing the attest function and to accountants engaged in internal auditing. The focus of this chapter will be on, primarily, those rules of conduct that apply to public accounting; many of those rules, such as independence, also apply to internal auditing. The references to public accountants or professional public accountants in this chapter are to CAs, CGAs, or CMAs who serve the public in a variety of ways through the firms to which they belong; the references are not to firms made up of individuals who may also provide services to the public but who do not have a professional designation.

What Are Ethics?

Ethics can be defined broadly as a set of moral principles or values. Each of us has such a set of values, although we may or may not have considered them explicitly. Philosophers, religious organizations, and other groups have defined in various ways ideal sets of moral principles or values. Examples of prescribed sets of moral principles or values at the implementation level include laws and regulations, church doctrine, codes of business ethics for professional groups such as CAs, CGAs, and CMAs, and codes of conduct within individual organizations such as accounting firms, corporations, and universities.

An example of a prescribed set of principles is that developed by the Josephson Institute for the Advancement of Ethics, included in Figure 3-1. The Josephson Institute was established as a not-for-profit foundation to encourage ethical conduct of professionals in the fields of government, law, medicine, business, accounting, and journalism.

It is common for people to differ in their moral principles or values. For example, a person might examine the Josephson Institute’s ethical principles and conclude that several principles should not be included. Even if two people agree on the ethical principles that determine ethical behaviour, it is unlikely that they will agree on the relative importance of each principle. These differences result from all of our life experiences. Parents, teachers, friends, and employers are known to influence our values, but so do television, team sports, life successes and failures, and thousands of other experiences.
Ethical behaviour is necessary for a society to function in an orderly manner. It can be argued that ethics is the glue that holds a society together. Imagine, for example, what would happen if we couldn’t depend on the people we deal with to be honest. If parents, teachers, employers, siblings, coworkers, and friends all consistently lied, it would be almost impossible for effective communication to occur.

The need for ethics in society is sufficiently important that many commonly held ethical values are incorporated into laws. For example, laws dealing with driving while intoxicated and selling drugs concern responsible citizenship and respect for others. Similarly, if a company sells a defective product, it can be held accountable if harmed parties choose to sue through the legal system.

A considerable portion of the ethical values of a society cannot be incorporated into law due to the judgmental nature of certain values. Looking again at Figure 3-1 at the honesty principle, it is practical to have laws that deal with cheating, stealing, lying, or deceiving others. It is far more difficult to establish meaningful laws that deal with many aspects of principles such as integrity, loyalty, and pursuit of excellence. That does not imply that these principles are less important for an orderly society.

| NEED FOR ETHICS |

The following list of ethical principles incorporates the characteristics and values that most people associate with ethical behaviour.

**Honesty**  Be truthful, sincere, forthright, straightforward, frank, candid; do not cheat, steal, lie, deceive, or act deviously.

**Integrity**  Be principled, honourable, upright, courageous, and act on convictions; do not be two-faced, or unscrupulous, or adopt an end-justifies-the-means philosophy that ignores principle.

**Promise Keeping**  Be worthy of trust, keep promises, fulfill commitments, abide by the spirit as well as the letter of an agreement; do not interpret agreements in an unreasonably technical or legalistic manner in order to rationalize noncompliance or create excuses and justifications for breaking commitments.

**Loyalty (Fidelity)**  Be faithful and loyal to family, friends, employers, clients, and country; do not use or disclose information learned in confidence; in a professional context, safeguard the ability to make independent professional judgments by scrupulously avoiding undue influence and conflicts of interest.

**Fairness**  Be fair and open-minded, be willing to admit error and, where appropriate, change positions and beliefs, demonstrate a commitment to justice, the equal treatment of individuals, tolerance for and acceptance of diversity, do not overreach or take undue advantage of another’s mistakes or adversities.

**Caring for Others**  Be caring, kind, and compassionate; share, be giving, be of service to others; help those in need and avoid harming others.

**Respect for Others**  Demonstrate respect for human dignity, privacy, and the right to self-determination of all people; be courteous, prompt, and decent; provide others with the information they need to make informed decisions about their own lives; do not patronize, embarrass, or demean.

**Responsible Citizenship**  Obey just laws; if a law is unjust, openly protest it; exercise all democratic rights and privileges responsibly by participation (voting and expressing informed views), social consciousness, and public service; when in a position of leadership or authority, openly respect and honour democratic processes of decision making, avoid unnecessary secrecy or concealment of information, and assure that others have all the information they need to make intelligent choices and exercise their rights.

**Pursuit of Excellence**  Pursue excellence in all matters; in meeting your personal and professional responsibilities, be diligent, reliable, industrious, and committed; perform all tasks to the best of your ability, develop and maintain a high degree of competence, be well informed and well prepared; do not be content with mediocrity, do not “win at any cost.”

**Accountability**  Be accountable, accept responsibility for decisions, for the foreseeable consequences of actions and inactions, and for setting an example for others. Parents, teachers, employers, many professionals, and public officials have a special obligation to lead by example, to safeguard and advance the integrity and reputation of their families, companies, professions, and the government itself; an ethically sensitive individual avoids even the appearance of impropriety, and takes whatever actions are necessary to correct or prevent inappropriate conduct of others.
Most people define unethical behaviour as conduct that differs from what they believe would have been appropriate given the circumstances. Each of us decides what constitutes ethical behaviour. It is important to understand what causes people to act in a manner that we decide is unethical.

There are two primary reasons why people act unethically: the person’s ethical standards are different from those of society as a whole, or the person chooses to act selfishly. In many instances, both reasons exist.

**Person’s ethical standards differ from general society** Extreme examples of people whose behaviour violates almost everyone’s ethical standards are drug dealers, bank robbers, and larcenists. Most people who commit such acts feel no remorse when they are apprehended because their ethical standards differ from those of society as a whole.

There are also many far less extreme examples where others violate our ethical values. When people cheat on their tax returns, treat other people with hostility, lie on employment applications, or perform below their competence level as employees, most of us regard that as unethical behaviour. If the other person has decided that this behaviour is ethical and acceptable, there is a conflict of ethical values that is unlikely to be resolved.

**The person chooses to act selfishly** The difference between ethical standards that differ from general society’s and acting selfishly is illustrated in the following example. Person A finds a briefcase in an airport containing important papers and $1,000. He tosses the briefcase and keeps the money. He brags to his family and friends about his good fortune. Person A’s values probably differ from most of society’s. Person B faces the same situation but responds differently. He keeps the money but leaves the briefcase in a conspicuous place. He tells nobody and spends the money on a new wardrobe. It is likely that Person B has violated his own ethical standards, but he has decided that the money was too important to pass up. He has chosen to act selfishly. What would you do? Shouldn’t the briefcase in its entirety be returned?

A considerable portion of unethical behaviour results from selfish behaviour. Political scandals result from the desire for political power; cheating on tax returns and expense reports is motivated by financial greed; performing below one’s competence and cheating on tests are typically due to laziness. In each case, the person knows that the behaviour is inappropriate but chooses to do it anyway because of the personal sacrifice needed to act ethically.

**Ethics in Business** There have been many well-publicized cases of failures by business persons to conduct their affairs consistently with society’s ethical values. For example, recently a well-known food manufacturer admitted to intentionally mislabelling a food product for the purpose of reducing product costs. Similarly, management of several financial institutions over the past decade has been charged with misusing company assets for personal gain and in some cases converting company assets to personal use.

There are several potential effects of these types of cases and the frequent criticisms of business in movies, television, and other media. One is to create the impression that unethical business behaviour is normal behaviour. Another is to conclude that management cannot conduct itself ethically and also have its business succeed financially. Finally and perhaps most important is to conclude that actions must be extreme to constitute unethical behaviour. There is considerable evidence that none of these conclusions about business ethics is correct. A large number of highly successful businesses follow ethical business practices because management believes that it has a social responsibility to conduct itself ethically, but also because it is good business to do so. For example, it is socially responsible to treat employees, customers, and vendors honestly and fairly, but in the long run such actions also result in business success.
The decision of management to operate its business ethically is not a new business philosophy. For example, in the 1930s, Rotary International developed its code of ethics that is still used extensively by millions of businesspeople. It uses four questions that are called the *Four Way Test* of ethical behaviour for any ethical issue a business faces:

- Is it the truth?
- Is it fair to all concerned?
- Will it build goodwill and better friendships?
- Will it be beneficial to all concerned?

Many companies have established their own formal ethical codes of conduct for management and employees. These codes are intended to encourage all personnel to act ethically and to provide guidance as to what constitutes ethical behaviour. For example, the second paragraph of “Management’s Responsibilities for Financial Statements” provided by Canadian Tire Corporation, Limited (Figure 5-4 on page 121) discusses management’s responsibility for its employees and internal policies.

### Ethical Dilemmas

An ethical dilemma is a situation a person faces in which a decision must be made about the appropriate behaviour. A simple example of an ethical dilemma is finding a diamond ring, which necessitates deciding whether to attempt to find the owner or to keep it. A far more difficult ethical dilemma to resolve is the following one; it is the type of case that might be used in an ethics course:

Qin Zhang is the in-charge on the September 30, 2001, audit of Paquette Forest Products Inc., a forest products company that produces lumber and paper products in northern Manitoba. The company employs 375 people and is the main employer in the remote town of Duck Lake, Manitoba; the other businesses in Duck Lake provide goods and services to Paquette Forest Products and its employees.

In the course of the audit, Qin discovers that the company has had a number of failures of the equipment that removes the sulphuric acid from the paper production process, and as a result, thousands of litres of untreated water have been dumped into the Loon River and Duck Lake. Qin learns that the cost of replacing the equipment so that no further spills are likely is much more than the company can afford and that if ordered to replace the equipment by the environment ministry, the company would be forced to cease operations. What should Qin do?

Auditors, accountants, and other businesspeople face many ethical dilemmas in their business careers. Dealing with a client who threatens to seek a new auditor unless an unqualified opinion is issued presents a serious ethical dilemma if an unqualified opinion is inappropriate. Deciding whether to confront a supervisor who has materially overstated departmental revenues as a means of receiving a larger bonus is a difficult ethical dilemma. Continuing to be a part of the management of a company that harasses and mistreats employees or treats customers dishonestly is a moral dilemma, especially if the person has a family to support and the job market is tight. Deciding whether or not to report negligence of a supervisor to a partner is a problem young staff accountants may face.

There are alternative ways to resolve ethical dilemmas, but care must be taken to avoid methods that are rationalizations of unethical behaviour. The following are rationalization methods commonly employed that can easily result in unethical conduct:

1. *Everybody does it.* The argument that it is acceptable to falsify tax returns, cheat on exams, or sell defective products is commonly based on the rationalization that everyone else is doing it and therefore it is acceptable.
2. *If it’s legal, it’s ethical.* Using the argument that all legal behaviour is ethical relies heavily on the perfection of laws. Under this philosophy, one would have no obligation to return a lost object unless the other person could prove that it was his or hers.

3. *Likelihood of discovery and consequences.* This philosophy relies on evaluating the likelihood that someone else will discover the behaviour. Typically, the person also assesses the severity of the penalty (consequences) if there is a discovery. An example is deciding whether to correct an unintentional overbilling to a customer when the customer has already paid the full billing. If the seller believes the customer will detect the error and respond by not buying in the future, the seller will inform the customer now; otherwise the seller will wait to see if the customer complains.

RESOLVING ETHICAL DILEMMAS

In recent years, formal frameworks have been developed to help people resolve ethical dilemmas. The purpose of such a framework is in identifying the ethical issues and deciding on an appropriate course of action using the person’s own values. The six-step approach that follows is intended to be a relatively simple approach to resolving ethical dilemmas:

1. Obtain the relevant facts. Care must be taken that assumptions are not taken as fact.
2. Identify the ethical issues from the facts.
3. Determine the stakeholders who are affected by the outcome of the dilemma and how each stakeholder is affected. (A stakeholder is a person or group who has a stake in an organization’s or an individual’s activities. A partial list of stakeholders of a company would include shareholders, creditors, managers and employees, customers, suppliers, the community, the government, and so on.)
4. Identify the alternatives available to the person who must resolve the dilemma.
5. Identify the likely consequence of each alternative.
6. Decide the appropriate action.

An illustration is used to demonstrate how a person might use this six-step approach to resolve an ethical dilemma.

ETHICAL DILEMMA

Bryan Longview has been working six months as a staff assistant for De Souza & Shah, public accountants. Currently he is assigned to the audit of Reyon Manufacturing Corp. under the supervision of Karen Van Staveren, an experienced audit senior. There are three auditors assigned to the audit, including Karen, Bryan, and a more experienced assistant, Martha Mills. During lunch on the first day, Karen says, “It will be necessary for us to work a few extra hours on our own time to make sure we come in on budget. This audit isn’t very profitable anyway, and we don’t want to hurt our firm by going over budget. We can accomplish this easily by coming in a half hour early, taking a short lunch break, and working an hour or so after normal quitting time. We just won’t write that time down on our time report.” Bryan recalls reading in the firm’s policy manual that working hours and not charging for them on the time report is a violation of De Souza & Shah’s employment policy. He also knows that seniors are paid bonuses, instead of overtime, whereas staff are paid for overtime but get no bonuses. Later, when discussing the issue with Martha, she says, “Karen does this on all of her jobs. She is likely to be our firm’s next audit manager. The partners think she’s great because her jobs always come in under budget. She rewards us by giving us good engagement evaluations, especially under the cooperative attitude category. Several of the other audit seniors follow the same practice.”
Relevant facts There are three key facts in this situation that deal with the ethical issue and how the issue will likely be resolved:

• The staff person has been informed he will work hours without recording them as hours worked.
• Firm policy prohibits this practice.
• Another staff person has stated that this practice is common practice for Karen and also for other seniors in the firm.

Ethical issue The ethical issue in this situation is not difficult to identify.

• Is it ethical for Bryan to work hours and not record them as hours worked in this situation?

Who are the stakeholders and how is each affected? There are typically more stakeholders affected in situations where ethical dilemmas occur than would normally be expected. The following are the key stakeholders involved in this situation:

<table>
<thead>
<tr>
<th>WHO</th>
<th>HOW AFFECTED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bryan</td>
<td>Being asked to violate firm policy.</td>
</tr>
<tr>
<td></td>
<td>Hours of work will be affected.</td>
</tr>
<tr>
<td></td>
<td>Pay will be affected.</td>
</tr>
<tr>
<td></td>
<td>Performance evaluations may be affected.</td>
</tr>
<tr>
<td></td>
<td>Attitude about firm may be affected.</td>
</tr>
<tr>
<td>Martha</td>
<td>Same as Bryan.</td>
</tr>
<tr>
<td>Karen</td>
<td>Success on engagement and in firm may be affected.</td>
</tr>
<tr>
<td></td>
<td>Hours of work will be affected.</td>
</tr>
<tr>
<td>De Souza &amp; Shah</td>
<td>Stated firm policy is being violated.</td>
</tr>
<tr>
<td></td>
<td>May result in underbilling clients in current and future engagements.</td>
</tr>
<tr>
<td></td>
<td>May affect firm’s ability to realistically budget engagements and bill clients.</td>
</tr>
<tr>
<td></td>
<td>May affect the firm’s ability to motivate and retain employees.</td>
</tr>
<tr>
<td>Audit staff assigned to Reyon</td>
<td>May result in unrealistic time budgets.</td>
</tr>
<tr>
<td>Manufacturing in the future</td>
<td>May result in unfavourable time performance evaluations.</td>
</tr>
<tr>
<td></td>
<td>May result in pressures to continue practice of not charging for hours worked.</td>
</tr>
<tr>
<td>Other staff in De Souza &amp; Shah</td>
<td>Following the practice on this engagement may motivate others to follow the same practice on other engagements.</td>
</tr>
</tbody>
</table>

Bryan’s available alternatives

• Refuse to work the additional hours.
• Perform in the manner requested.
• Inform Karen that he will work the additional hours and will charge the additional hours to the engagement.
• Talk to a manager or partner about Karen’s request.
• Refuse to work on the engagement.
• Quit working for the firm.

Each of these options includes a potential consequence, the worst likely one being termination by the firm.

Consequences of each alternative In deciding the consequences of each alternative, it is essential to evaluate both the short- and long-term effects. There is a natural tendency to emphasize the short term because those consequences will occur quickly, even when the long-term consequences may be more important. For example, consider the potential consequences if Bryan decides to work the additional hours and not report them. In the short term, he will likely get good evaluations for cooperation and perhaps a salary increase. In the longer term, what will be the effect of not reporting the hours this time when other ethical conflicts arise? Consider the following similar ethical dilemmas Bryan might face in his career as he advances:
• An audit firm supervisor asks Bryan to work three unreported hours daily and 15 each weekend.
• An audit firm supervisor asks Bryan to initial certain audit procedures as having been performed when they were not.
• Bryan concludes that he cannot be promoted to manager unless he persuades assistants to work hours that they do not record.
• Management of a client informs Bryan, who is now a partner, that either the company gets an unqualified opinion for a $40,000 audit fee or the company will change auditors.
• Management of a client informs Bryan that the audit fee will be increased by $25,000 if Bryan can find a plausible way to increase earnings by $1 million.

Notice how each dilemma is more serious than the one preceding it; the penalty that Bryan would face if he were to be caught grows more severe as the dilemma grows more serious. In short, if Bryan agrees to work the additional hours and not report them, he has put himself on a slippery slope that grows ever steeper.

Appropriate action Only Bryan can decide the appropriate option to select in the circumstances after considering his ethical values and the likely consequences of each option. At one extreme, Bryan could decide that the only relevant consequence is the potential impact on his career. Most of us would conclude that Bryan is an unethical person if he follows that course. At the other extreme, Bryan can decide to refuse to work for a firm that permits even one supervisor to violate firm policies. Many people would consider such an extreme reaction naive.

Our society has attached a special meaning to the term “professional.” A professional is expected to conduct himself or herself at a higher level than most other members of society. For example, when the press reports that a physician, clergyperson, member of Parliament, or CA, CGA, or CMA has been indicted for a crime, most people feel more disappointment than when the same thing happens to people who are not labelled as professionals.

The term “professional” means a responsibility for conduct that extends beyond satisfying the person’s responsibilities to himself or herself and beyond the requirements of our society’s laws and regulations. A CA, CGA, or CMA in public practice, as a professional, recognizes a responsibility to the public, to the client, and to fellow practitioners, including honourable behaviour, even if that means personal sacrifice.

The underlying reason for a high level of professional conduct by any profession is the need for public confidence in the quality of service by the profession, regardless of the individual providing it. For the professional public accountant, it is essential that the client and external financial statement users have confidence in the quality of audits and other services. If users of services do not have confidence in physicians, judges, or public accountants, the ability of those professionals to serve clients and the public effectively is diminished.

It is not practical for users to evaluate the performance of professional services because of their complexity. A patient cannot be expected to evaluate whether an operation was properly performed. A financial statement user cannot be expected to evaluate audit performance. Most users have neither the competence nor the time for such an evaluation. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and conduct on the part of all practitioners.

In recent years, increased competition has made it more difficult for professional public accountants and many other professionals to conduct themselves in a professional manner. Increased competition sometimes has the effect of making public accounting firms more concerned about keeping clients and maintaining a reasonable profit. Because of the increased competition, many public accounting firms have...
implemented philosophies and practices that are frequently referred to as *improved business practices*. These include such things as improved recruiting and personnel practices, better office management, and more effective advertising and other promotional methods. Public accounting firms are also attempting to become more efficient in doing audits in a variety of ways. For example, they are obtaining efficiency through the use of computers, effective audit planning, and careful assignment of staff.

Most people, including the authors, believe these changes in practice are desirable for our society’s benefit as long as they do not interfere with the conduct of CAs, CGAs, or CMAs as professionals. A public accounting firm can implement effective business practices and still conduct itself in a highly professional manner.

Public accounting firms who provide attestation services have a different relationship with users of financial statements than most other professionals have with the users of their services. Lawyers, for example, are typically engaged and paid by a client and have primary responsibility to be an advocate for that client. Public accounting firms providing attestation services are engaged and paid by the company issuing the financial statements, but the primary beneficiaries of the audit are statement users. Frequently the auditor doesn’t know or have contact with the statement users, but has frequent meetings and ongoing relationships with client personnel.

It is essential that users regard such public accounting firms as competent and unbiased. If users were to believe that such public accounting firms do not perform a valuable service (reduce information risk), the value of those firms’ audit and other assurance services would be reduced, and the demand for audits would thereby also be reduced. There is, therefore, considerable incentive for such public accounting firms to conduct themselves at a high professional level.

There are several ways in which society and the accounting bodies whose respective members are in public practice conducting audits (e.g., CAs and CGAs) encourage those in public practice to conduct themselves appropriately and to do high-quality audits and related services. Figure 3-2 shows the most important ways. Several of these were discussed in Chapter 1, including GAAS requirements and the Recommendations of the CICA Handbooks, professional examinations, quality control, the provincial securities commissions, practice inspection, and continuing education. The ability of individuals to sue public accounting firms also exerts considerable influence on the way practitioners conduct themselves and audits. Legal liability is
studied in Chapter 4. The code of professional conduct of the public accountant’s respective accounting body also has a significant influence on the practitioner. It is meant to provide a standard of conduct for members of that body. These codes, some of their more important tenets, and related issues of professional conduct are the content of the remainder of this chapter.

**Code of Professional Conduct**

A code of conduct can consist of general statements of ideal conduct or specific rules that define unacceptable behaviour. The advantage of general statements is the emphasis on positive activities that encourage a high level of performance. The disadvantage is the difficulty of enforcing general ideals because there are no minimum standards of behaviour. The advantage of carefully defined specific rules is the enforceability of minimum behaviour and performance standards. The disadvantage is the tendency of some practitioners to define the rules as maximum rather than minimum standards. A second disadvantage is that some practitioners may view the code as the law and conclude that if some action is not prohibited, it must be ethical. A practitioner must consider the intent of the code in addressing whether a particular action is acceptable or not.

A professional code of conduct serves both the members of the body promulgating the code and the public. It serves members by setting standards the members must meet and providing a benchmark against which the members will be measured by their peers. The public is served because the code provides them with a list of the standards to which the members of the body should adhere and helps them determine their expectations of members’ behaviour.

The provincial institutes and Quebec ordre of chartered accountants determine the rules of professional conduct for members and students of that provincial institute or ordre. The provincial institutes and ordre have harmonized their rules of professional conduct so that, generally, the same set of rules applies to all CAs in Canada. Certain rules (e.g., confidentiality, which is discussed below) apply to students as well as to members. All of the rules apply to members in public practice, while a smaller number of them also apply to members who are not engaged in the practice of public accounting. The profession is moving to have the rules of conduct apply to public accounting firms as well as to individual members. Several years previously, only individual members of a firm could face charges before the Discipline Committee.

The rules of conduct for certified general accountants are determined by the CGAAC and apply to all CGAs in Canada; the provincial associations are charged with administering the code and have the power to amend and add to this national code of conduct. The rules do not apply to students. While all the rules apply to members in public practice, certain of the rules apply also to “accountants in employment”; that is, members not in public practice.

The rules of conduct for certified management accountants are a provincial matter. They do not apply to students who are aspiring to become members. The provincial societies do not differentiate between members in public practice and other members, although certain rules do apply to members in public practice.

Generally the codes of conduct of the three professional accounting bodies, the CICA, the CGAAC, and the SMAC, have attempted to accomplish both the objectives of general statements of ideal conduct and of specific rules. For example, there are three parts to the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario: principles which are stated in broad terms, the rules themselves, and interpretation of the rules. Figure 3-3 is illustrative. The parts are listed in order of increasing specificity: the principles provide ideal standards of conduct, whereas ethical rulings are more specific, and the interpretations are very specific.
The principles generally are characteristics that the professional body deems desirable in its members. An organization is judged by the behaviour of its members; therefore, one principle would be that members behave in a way that enhances and does not detract from the reputation of all the members. Members should act ethically and act in a way that will serve the public interest. When a member of a profession is disciplined by the courts, the profession’s reputation suffers along with that of the member. It is a mistake to think that only the member loses his or her reputation in such a situation.

Other common principles are that members act with integrity and due care in the performance of their professional activities, that they maintain (i.e., keep current) their professional competence, that they do not undertake work for which they lack the necessary competence, and that they behave in a professional way towards colleagues. The accountant must maintain confidentiality with respect to the affairs and business of the client. There is one principle that relates more specifically to public accountants: the accountant should ensure that he or she maintains an independent or objective state of mind when providing assurance services (e.g., audits or reviews) for clients.

A careful examination of these principles will likely lead to the conclusion that most are applicable to any professional, not just professional accountants. For example, physicians should behave in a way that is not discreditable to their profession, they should act ethically and in a way that serves the public interest, and they should exercise integrity and due care. Physicians should maintain their professional competence and behave in a professional way towards their colleagues. They should not breach their clients’ confidentiality. One difference between auditors and other professionals, as discussed earlier, is that most professionals need not be concerned about remaining independent.

These principles will be explored more fully in the balance of this chapter.

The discussion that follows will consider some of the more important rules of conduct followed by public accountants in Canada. A student interested in obtaining a particular professional designation (e.g., CA, CGA, or CMA) should refer to and become familiar with the specific rules of conduct of the body to which he or she seeks admission.

As was mentioned previously, while all the rules discussed below apply to members of the professional accounting bodies in public practice, some of the rules discussed do not apply to members who are not engaged in the practice of public accounting. The difference will be apparent in the ensuing discussion.

Figure 3-3 indicated that while principles are not enforceable, the rules of conduct are. For that reason, the rules of conduct of the accounting bodies are stated in more precise language than the principles can be. Because of their enforceability, the rules are often called Rules or Code of Professional Conduct.
At what level do practitioners conduct themselves in practice? As in any profession, the level varies among practitioners. Some operate at high levels, whereas others operate as close to the minimum level as possible. Unfortunately, some also conduct themselves below the minimum level set by the profession. It is hoped that there are few of those.

**INTERPRETATIONS OF RULES OF CONDUCT**

The need for published interpretations of the rules of conduct arises when there are frequent questions from practitioners about a particular rule. The various institutes and ordre of chartered accountants issue interpretations of certain rules of conduct together with the rules themselves. Interpretations are not officially enforceable, but a departure from the interpretations would be difficult, if not impossible, for a practitioner to justify in a disciplinary hearing.

**APPLICABILITY OF THE RULES OF CONDUCT**

As was mentioned previously, the rules of conduct for CAs and CGAs specifically state that while the rules are for all CAs and CGAs respectively, certain rules, because of their nature, may not apply to members who are not in public practice.

It would be a violation of the rules if someone did something on behalf of a member that would have been a violation if the member had done it. An example is a banker who states in a newsletter that Johnson and Able, public accountants, have the best tax department in the province and consistently get large refunds for their tax clients. That is likely to create false or unjustified expectations and is a violation of both the CA and CGA rules of conduct.

A member is also responsible for compliance with the rules by employees and partners.

**DEFINITIONS**

A few definitions must be understood to minimize misinterpretation of the rules to be discussed below.

- **Client** — the person(s) or entity which retains a member or his or her firm, engaged in the practice of public accounting, for the performance of professional services.
- **Firm** — a proprietorship or partnership engaged in the practice of public accounting, including individual partners thereof.
- **Member** — a member of the Canadian Institute of Chartered Accountants (and a provincial institute or ordre) or of the Certified General Accountants Association of Canada (and a provincial association).
- **Practice of public accounting** — holding out to be a public accountant and at the same time performing for a client one or more types of services rendered by public accountants.

**SUMMARY OF THE BASIC COMPONENTS OF A CODE OF CONDUCT**

The intent of this section is to discuss several rules of conduct that are fundamental to the practice of public accounting. As such, they are found in differing forms and to differing degrees in the rules of professional conduct of CAs, CGAs, and CMAs. It must be pointed out that the rules of conduct governing the behaviour of these three groups of professionals are much more extensive and detailed than the ensuing discussion.

**Independence**

Generally, the rules of conduct promulgated by the accounting bodies require their members who are engaged in the practice of public accounting to be independent when they perform certain functions. For example, the rules require that auditors of
historical financial statements be independent. Independence is usually required for other types of attestation engagements such as review engagements. However the rules usually permit a public accounting firm to do tax returns and provide management services without being independent.

As you learned in Chapter 1, independence is also very important for internal auditors if they are to properly carry out their jobs. Standards for the Professional Practice of Internal Auditing published by the Institute of Internal Auditors provides guidance to persons engaged in internal auditing, not just to members of the IIA. The first standard in the publication states that “Internal auditors should be independent of the activities they audit.” It is possible for internal auditors to be independent even though they are employees of their client; this can be accomplished through the internal auditor’s organizational status and by the internal auditor having an independent mental attitude. The ensuing discussion will focus on attest audits but applies equally to internal audits.

Independence in auditing means taking an unbiased viewpoint in the performance of audit tests, the evaluation of the results, and the issuance of the auditor’s report. If the auditor is an advocate for the client, a particular banker, or anyone else, he or she cannot be considered independent. Independence must certainly be regarded as the auditor’s most critical characteristic. The reason that many diverse users are willing to rely upon the professional public accountant’s reports as to the fairness of financial statements is their expectation of an unbiased viewpoint.

Not only is it essential that professional public accountants maintain an independent attitude in fulfilling their responsibilities, but it is also important that the users of financial statements have confidence in that independence. These two objectives are frequently identified as independence in fact and independence in appearance. Independence in fact exists when the auditor is actually able to maintain an unbiased attitude throughout the audit, whereas independence in appearance is the result of others’ interpretation of this independence. If auditors are independent in fact but users believe them to be advocates for the client, most of the benefit of the audit function will be lost.

Although it is possible to take the extreme position that anything affecting either independence in fact or in appearance must be eliminated to ensure a high level of respect in the community, it is doubtful whether this would solve as many problems as it would create. The difficulty with this position is that it is likely to restrict significantly the services offered to clients, the freedom of public accountants to practise in the traditional manner, and the ability of public accounting firms to hire competent staff. At this point it will be helpful to examine some conflicts of independence that have arisen, evaluate their significance, and determine how the profession has resolved them.

Independence may be broadly thought of as having four facets:

- financial independence
- independence of mental attitude
- investigative independence
- reporting independence

The four facets essential to independence are discussed in turn below.

**Financial independence** Financial independence relates to not having a financial interest in the client and may be manifested by not

- owning stock in the client.
- owing a significant amount of money to or being owed a significant amount of money by a client.
- having a single client whose fee(s) represents a major portion of the public accountant’s total revenue.
• being engaged and paid by management. In some audit situations, while the shareholders appoint the auditors at their annual meeting, in fact the shareholders are voting on a public accounting firm suggested by management, the very people whose work the auditor will be reviewing. One way to improve the situation is to have the audit committee of the board of directors nominate the auditors. Independence is also enhanced if the audit committee, which is discussed in more detail below, sets the audit fee and determines the scope of the audit in consultation with the auditors.

• performing management advisory services for the client. This point has been contentious for a number of years. One group believes that an auditor can become so beholden to a client that the auditor will fail to have the appropriate scepticism; for example, the consulting fee may exceed the audit fee. Another group believes that the public accountant’s professionalism will result in a proper audit and that there are synergistic effects for both the audit and the management advisory services flowing from the same firm doing both. The issue is not resolved; there are no specific prohibitions to performing management consulting for an audit client in the various rules of professional conduct.

Rules of conduct of the CAs, CGAs, and CMAs deal with financial independence because lack of independence is likely to affect the users’ perception of the auditors’ independence. It is the authors’ experience that individual public accounting firms often have rules with respect to financial independence that are more stringent than those of the professional association. Some public accounting firms do not permit any ownership by staff of a client’s stock regardless of which office of the firm serves the client. These firms have decided to have higher requirements than the minimums set by the rules of conduct of the various professional associations.

**Independence of mental attitude** An independent mental attitude is essential to achieving independence in fact. Paragraph 5090.04 of the *CICA Handbook* states that “The auditor performs the audit with an attitude of professional scepticism” while assuming management’s good faith. Paragraph 5090.04 captures the spirit of independence of mental attitude. The auditor should not allow long association or friendship to colour his or her evaluation, nor should the auditor approach an audit with the view that management and the employees are dishonest.

An auditor’s professionalism dictates that the auditor be unbiased; however, there is no yardstick, as there is with financial independence, to measure whether or not the auditor has an independent mental attitude. This is an issue that the auditor must decide for himself or herself.

**Investigative independence** Investigative independence means that the auditor has the time and resources (i.e., the fee is adequate for the job and staffing is appropriate for the job) to obtain sufficient appropriate audit evidence and that the auditor has access to all evidence needed to reach the proper opinion as to the fairness of the financial statements. Investigative independence would be impaired if there was a deadline so that the job was rushed, if the fee was too low so that the auditor cut back on testing, or if the auditor was denied access to evidence (e.g., if the auditor were not permitted to count inventory).

**Reporting independence** Reporting independence means reporting at a sufficiently high level that the report will be acted on. For example, an auditor who reported to management when the auditor believed management to be guilty of fraud would not have reporting independence. On the other hand, if the auditor reported to an audit committee (discussed below) made up of independent (i.e., non-management) members of the board of directors, the auditor would have reporting independence.
Summary  Independence is broader than not owning shares in a client. The four facets of independence discussed above take the broadest view of independence; all four must be present if the auditor is to be truly independent.

AUDIT COMMITTEE

An audit committee is a selected number of members of a company’s board of directors who provide a forum that is independent of management for both the external and internal auditors. Most audit committees are made up of three to five or sometimes as many as seven directors. Incorporating acts generally require that the majority of the committee must be outside directors (i.e., not part of company management).

A typical audit committee decides such things as which public accounting firm to retain and the scope of services the public accounting firm is to perform. The audit committee also meets with the public accounting firm to discuss the progress and findings of the audit and helps resolve conflicts between the public accounting firm and management. Many of the same comments could be made about the audit committee and the internal auditors. While audit committees are looked upon with favour by most auditors, users, and management, they exist mainly on the boards of directors of larger companies.

Section 171(1) of the Canada Business Corporations Act states that an audit committee is required for all companies incorporated under the Act that distribute their securities to the public. Section 171(2) permits the director who administers the Canada Business Corporations Act to waive this requirement if he or she thinks such a waiver is appropriate. The sole duty required of a member of the audit committee by the Act, in Section 171(3), is to review the financial statements before they are issued. Other incorporating acts also require corporations to have audit committees; the responsibilities assigned to the committee vary.

The auditor has the right to attend meetings of the audit committee and to call meetings if he or she feels they are necessary. Directors who become aware of any misstatements in issued financial statements must notify the auditor and the audit committee of the misstatements.

The audit committee may do the minimum required by statute or may be more active. Among other activities, some audit committees

- Review the entire annual report
- Review the scope and cost of the audit with the external auditors
- Act as a liaison between the external auditors and management
- Adjudicate disputes between the external auditors and management
- Act as a liaison between the internal auditors and management
- Adjudicate disputes between the internal auditors and management

Needless to say, the audit committee can add significantly to the external auditor’s, as well as the internal auditor’s, independence.

BOOKKEEPING SERVICES AND AUDITS FOR THE SAME CLIENT

If a public accountant records transactions in the journals for the client, posts monthly totals to the general ledger, makes adjusting entries, and subsequently does an audit, there is some question as to whether the public accountant can be independent in his or her audit role. Generally, the rules of conduct permit a public accounting firm to do both bookkeeping and auditing for the same client. This conclusion is presumably based on a comparison of the effect on independence of having both bookkeeping and auditing services performed by the same public accounting firm with the additional cost of having a different public accounting firm do the audit. There are three important requirements that the auditor should satisfy before it is acceptable to do bookkeeping and auditing for the client:

1. The client must accept full responsibility for the financial statements. The client must be sufficiently knowledgeable about the enterprise’s activities and finan-
cial condition and the applicable accounting principles so that the client can reason-
ably accept such responsibility, including the fairness of valuation and pre-
sentation and the adequacy of disclosure. When necessary, the public
accountant should discuss accounting matters with the client to be sure that the
client has the required degree of understanding.

2. The public accountant must not assume the role of employee or of management
conducting the operations of an enterprise. For example, the public accountant
should not consummate transactions, have custody of assets, or exercise author-
ity on behalf of the client. The client must prepare the source documents on all
transactions in sufficient detail to identify clearly the nature and amount of such
transactions and maintain accounting control over data processed by the public
accountant, such as control totals and document counts.

3. The public accountant, in making an examination of financial statements pre-
pared from books and records that the public accountant has maintained com-
pletely or in part, must conform to generally accepted auditing standards. The
fact that the public accountant has processed or maintained certain records does
not eliminate the need to perform sufficient audit tests.

The first two requirements are often difficult to satisfy for smaller clients where
the owner may have little knowledge of or interest in accounting or processing
transactions.

AIDS TO
MAINTAINING
INDEPENDENCE

The accounting profession and society, especially in the past decade, have been con-
cerned about ensuring that (1) auditors maintain an unbiased attitude in performing
their work (independence in fact) and (2) users perceive auditors as being indepen-
dent (independence in appearance). Many of the elements shown in Figure 3-2 and
other requirements or inducements encourage public accountants to maintain inde-
pendence in fact and appearance. These are now briefly summarized. The most
important have already been discussed in Chapter 1 and early in Chapter 2.

Legal liability The penalty involved when a court concludes that a practitioner is
not independent can be severe, including criminal action. The courts have certainly
provided major incentives for auditors to remain independent. Legal liability is stud-
ied in Chapter 4.

Rules of professional conduct The existing rules of conduct restrict public accoun-
tants in their financial and business relationships with clients. They are a consider-
able aid in maintaining independence.

Generally accepted auditing standards The general standards require the auditor
to maintain an objective state of mind in all matters related to the assignment.

Public accounting firm quality control standards Most public accounting firms
establish policies and procedures to provide reasonable assurance that all personnel
are independent.

Audit committee An audit committee, as was recently discussed, can help auditors
remain independent of management.

Shopping for accounting principles Management may consult with other accoun-
tants on the application of accounting principles. Although consultation with other
accountants is an appropriate practice, it can lead to a loss of independence in certain
circumstances. For example, suppose one public accounting firm replaces the exist-
ing auditors on the strength of accounting advice offered but later finds facts and cir-
cumstances that require the public accounting firm to change its stance. It may be
difficult for the new public accounting firm to remain independent in such a situation. The Assurance Standards Board issued Section 7600, "Reports on the Application of Accounting Principles, Auditing Standards or Review Standards," setting out requirements that must be met when a public accounting firm is requested to provide a written opinion on the application of accounting principles or auditing standards by a party other than the client (also discussed in Chapter 23). Such an opinion would be issued for specific circumstances or transactions relating to an audit, review, or compilation client of another public accounting firm. It applies if the public accountant is asked to provide a generic or hypothetical opinion on the application of accounting principles or auditing standards.

The purpose of Section 7600 is to minimize the likelihood of management following the practice commonly called "opinion shopping" and the potential threat to independence of the kind described above. Primary among the requirements is that the consulted or "reporting" accounting firm should communicate with the entity’s incumbent accountant to ascertain all the available facts relevant to forming a professional judgment on the matters the firm has been requested to report on.

**Approval of auditor by shareholders**  The *Canada Business Corporations Act* and other incorporating acts require shareholders to approve the selection of a new auditor or continuation of the existing one. Shareholders are usually a more objective group than management. It is questionable, however, whether they are in a position to evaluate the performance of previous or potential auditors.

**Conclusion**  Regardless of the rules set forth by the rules of conduct of the various accounting bodies, it is essential that the public accountant maintain an unbiased relationship with management and all other parties affected by the performance of the public accountant's responsibilities. In every engagement, including those involving management advisory and tax services, the public accountant must not subordinate his or her professional judgment to that of others. Even though pressures on the public accountant’s objectivity and integrity are frequent, the long-run standing of the profession in the financial community demands resisting those pressures. If the conflicts are sufficiently great to compromise the public accountant's independence, it may be necessary for the public accounting firm to resign from the engagement.

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**Confidentiality**

**OBJECTIVE 3-6**

Discuss confidentiality as it applies to a public accountant.

The rules of conduct for CAs, CGAs, and CMAs state that members shall not disclose any confidential client or employer information without the specific consent of the client or employer. In general, the rules also prohibit using confidential or inside information to earn profits or benefits.

The rule against disclosure does not apply if the member is called upon to disclose the information by the courts. Communication between an auditor and client is not privileged as it is between lawyer and client; a court can require a public accountant to produce all files and documents held by the public accountant including confidential advice provided to the client by the public accountant. For this reason, the auditor must be careful what information is put into the file, recognizing that the file could appear as a court document. The rule against disclosure also does not apply if the member’s professional body requires the confidentiality rule to be waived in connection with the body’s exercise of its duties (e.g., when an auditor is called upon to produce working papers in connection with the disciplinary process, or when an auditor is required to produce files as part of practice inspection).

While the rules of professional conduct with respect to confidentiality are quite clear, as you will discover in Chapter 4, the auditor may be confronted with a situation where he or she must choose between confidentiality and other rules of conduct or another course of action. For example, Objective 4-7 in Chapter 4 discusses the auditor’s legal responsibilities for client confidentiality. A situation is described
where an auditor has two clients who deal with each other; the auditor must choose between violating the rule respecting confidentiality or the rule respecting association with false or misleading financial information. Chapter 4, in the two legal cases reviewed on page 105, also illustrates the conflict that arises when an auditor has information about one client that could be beneficial to a second client. The situation described and the two legal cases mentioned demonstrate how auditors face ethical dilemmas where they cannot rely on the rules of conduct to provide a solution.

During an audit or other type of engagement, practitioners obtain a considerable amount of information of a confidential nature, including officers’ salaries, product pricing and advertising plans, and product cost data. If auditors divulged this information to outsiders or to client employees who have been denied access to the information, their relationship with management would be seriously strained and, in extreme cases, would cause the client harm. The confidentiality requirement applies to all services provided by public accounting firms, including tax and management services.

Ordinarily, the public accounting firm’s working papers can be provided to someone else only with the express permission of the client. This is the case even if a public accountant sells his or her practice to another public accounting firm or is willing to permit a successor auditor to examine the working papers prepared for a former client. Permission is not required from the client, however, if the working papers are subpoenaed by a court or are used as part of practice inspection. If the working papers are subpoenaed, the client should be informed immediately. The client and the client’s lawyer may wish to challenge the subpoena.

The rules of all three accounting bodies in Canada require their members to behave in the best interest of their profession and the public. This means accountants should not take advantage of the trust placed in them by their profession and by the public. It means that an accountant should not be publicly critical of a colleague (i.e., by making a complaint about the colleague’s behaviour to their professional body or by being critical, as a successor auditor, to the new client) without giving the colleague a chance to explain his or her actions first.

Actions by a member of a professional body — in law, medicine, or any other profession — reflect not only on the member but also on the body itself. For example, a lawyer who steals trust monies sullies not only his or her own reputation but also that of the law profession; the theft brings all lawyers into disrepute. Reputation is affected by anti-social behaviour such as harassment and discrimination, since such behaviour is considered abhorrent, resulting in professional disciplinary actions. Therefore, it is essential that an accountant behave in an exemplary manner as a member of the professional body.

The rules of conduct for CAs, CGAs, and CMAs require their members to act with integrity and due care. Integrity is one of the hallmarks of the profession. One of a professional accountant’s most important assets is his or her reputation for honesty and fair dealing; if users of financial statements audited by or prepared by an accountant do not believe in the practitioner’s honesty or fairness, the value of the financial statements or the audit is diminished. The professional accountant’s behaviour with clients, colleagues, employers, and employees must be above reproach.

Due care in the performance of his or her duties is also a hallmark of a professional. The public accountant has a legal duty of care to certain users of financial statements, as will be seen in Chapter 4. Due care means the application by a profes-
sional of a level of care and skill in accordance with what would reasonably be expected of a person of his or her rank and training. Note that due care is mentioned in the general standard of GAAS in Section 5100 of the CICA Handbook.

**Competence**

**OBJECTIVE 3-9**

Discuss the responsibility of a public accountant to maintain professional competence.

As a professional, a CA, CGA, or CMA has a responsibility to maintain his or her professional competence. The rules of conduct of the three professional bodies require practitioners to maintain competence; similarly the GAAS state the necessity of “adequate technical training and proficiency.” The public expects that all professionals will strive to keep abreast of the latest techniques and methodologies.

The accounting associations offer continuing professional education courses in a variety of subject areas to assist their members in maintaining their competence. In addition, there are a number of other organizations which provide courses.

Members are encouraged to keep current in a variety of ways. The various institutes and the ordre of chartered accountants have practice inspections (discussed in Chapter 1) over a four-year period of all public practice units. Certified general accountants are required to attend a certain number of continuing professional education courses a year. Primarily, however, it is a professional accountant’s professionalism that dictates that he or she keep current.

The general standard, of GAAS explicitly and of the rules of conduct of the various professional accounting bodies implicitly, requires the auditor to have the necessary technical knowledge and competence to conduct the audit. This is especially true as businesses — and accounting for them — increase in complexity. An auditor should not undertake an audit of a client unless that auditor has both knowledge of that client’s business and industry and of the technical aspects of the audit itself. For example, the audit of an insurance company requires knowledge of auditing the policy reserves that form a significant part of the insurance company’s liabilities. Many of the larger accounting firms are forming industry specialization groups within the firm that are responsible for all audits within their specialty.

An audit firm should decline a new audit if the firm either lacks or does not have access to the technical knowledge required to complete the audit. Similarly, an auditor within a firm should ensure that he or she has access to the technical knowledge required to complete the audit.

**Adherence to GAAP and GAAS**

**OBJECTIVE 3-10**

Discuss the responsibility of a public accountant neither to associate himself or herself with false or misleading information nor to fail to reveal material omissions from the financial statements, but rather to comply with the standards of practice incorporated in the Recommendations of the CICA Handbooks.

All three professional accounting bodies require their members in practice as public accountants and working in industry not to associate themselves with false or misleading information or to fail to reveal material omissions from financial statements. Users of financial statements prepared by or audited by professional accountants are entitled to believe that the financial statements are complete and fairly present the financial position of the company. They are entitled to believe that the financial statements are not false and misleading. They are entitled to rely on the integrity of the accountants involved.

Given that public trust of professional accountants does exist, if an accountant were to betray this trust and provide a clean opinion on financial statements he or she knows to be misleading, users would accept the statements as correct and would suffer a loss. Objective 3-8 discusses integrity and its importance to a public accountant; discovery that the public accountant was associated with false and misleading financial information or failed to reveal a material fact would destroy the accountant’s reputation for integrity.

CAs, CGAs, and CMAs are required to comply with professional standards when preparing and auditing financial statements. These standards would include the standards of the professional body but, more importantly, GAAP and GAAS as set out in the CICA Handbooks. As you learned in Chapter 1, the Canada Business Corpora-
visions Act and the incorporating acts of many of the provinces require financial statements to be prepared according to GAAP as specified by the CICA Accounting Handbooks and also require the auditor’s report to be in accordance with the standards of the CICA Assurance Handbook. The Canadian Securities Administrators, who set policy for the securities commissions and stock exchanges in Canada, also specify the Handbooks as the source of GAAP.

**Advertising and Solicitation**

A profession’s reputation is not enhanced if the members openly solicit one another’s clients or engage in advertising that is overly aggressive, self-laudatory, or critical of other members of the profession, or that makes claims that cannot be substantiated. As a consequence, the three professional accounting bodies in Canada either explicitly or implicitly prohibit solicitation of another public accountant’s client and advertising that is not in keeping with the profession’s high standards.

Responding to a request for information from a client of another public accounting firm is not solicitation, nor is responding to an invitation to tender from another firm’s client. Rather, solicitation is approaching the client of another public accounting firm to convince him or her to switch to one’s own firm. It is a targeted act of seeking a specific professional engagement.

Advertising that is in good taste is acceptable. It may include complimentary material about the accounting firm but should not claim any superior skills or make promises that can’t be kept (e.g., a promise that certain favourable results will be achieved). Advertising is a general process of informing potential users of the availability of services.

There has been a gradual change over the past few years as the rules regarding solicitation and advertising have been made less stringent. As a consequence, advertising in the various media is much more common. There is an increased emphasis on marketing and more competitive pricing of services. Many public accounting firms have developed sophisticated advertising for national journals read by businesspeople and for local newspapers. It is common for public accounting firms to make formal and informal presentations at the request of management in order to convince them to change public accounting firms. Price bidding for audits and other services is now common and often highly competitive. As a result of these changes, some companies now change auditors more often than they did previously to reduce audit cost.

**Other Rules**

Has the quality of audits become endangered by these changes? The existing legal exposure of public accountants, the disciplinary processes of the professional accounting bodies, practice inspection requirements, and the potential for interference by the securities commissions and government has kept audit quality high. In the opinion of the authors, the changes in the rules have caused greater competition in the profession, but not so much that high-quality, efficiently run public accounting firms have been significantly harmed. However, for this to continue to be so, public accounting firms need to be on guard so that increasing competitive pressures do not cause auditors to reduce quality below an acceptable level.

**Breaches of the rules** The rules of conduct of the professional accounting bodies require members who are aware of a breach of the rules by another member to report that member to the profession’s discipline committee after first advising the member of the intent to make a report. The three bodies are self-regulating and therefore must police themselves. It is important that the member be notified of the intent to report the breach in case there are mitigating circumstances of which the reporting member is not aware.
Contingent fees  The charging of a fee based on the outcome of an audit, such as the granting of a loan by a bank, could easily impair the auditor’s independence. Contingent fees are prohibited for audits, reviews, and any other engagements that require the auditor to be objective.

Communication with predecessor auditor  The rules of conduct of the CAs and CGAs and incorporating acts such as the Canada Business Corporations Act require a (potential) successor auditor, prior to accepting an appointment as auditor, to communicate with the incumbent auditor to inquire if there are any circumstances of which the incumbent is aware that might preclude the successor from accepting the appointment. The successor would ask the potential client to authorize the incumbent to provide the information requested. If the client refuses to do so, the successor should be reluctant to accept the appointment because it is likely that the client is hiding something.

Professionalism dictates that the incumbent should respond to the successor’s request and be candid in responding. However, the incumbent may not respond or may not be as frank as he or she could be.

The communication between the incumbent and the successor is important because it prevents a successor from unknowingly accepting an appointment that might, if all the facts were known, be rejected. For example, if the incumbent resigned after finding that management of the client was dishonest and was engaged in fraud, it is unlikely any public accounting firm would accept the client if the incumbent had passed on that knowledge. In short, the required communication protects prospective successors, and thus the profession, from getting involved with undesirable clients. Review of the previous auditor’s working papers is an important part of the audit process, as discussed further in audit planning. The client acceptance decision is discussed in Chapter 7.

Professional liability insurance  In several provinces, members practising public accounting are required to carry professional liability insurance. Two issues arise that can cause confusion: defining what is public accounting, and the extent of work being done for no remuneration.

For example, during tax season, individuals may prepare tax returns for family and friends at no charge. Since basic advice such as maximization of RRSP contributions is often included, this process is considered to be practising public accounting. However, if only a limited number of returns are being prepared for no remuneration, a public practice is not being carried on. If more than a handful of returns are being prepared and fees are being charged, either on a full- or part-time basis, then professional liability insurance would be required.

Other rules  The rules of conduct of the professional accounting bodies include many more rules than have been described here; an aspiring professional accountant should make himself or herself aware of the rules of conduct of the professional body to which membership is sought. The rules not covered, and those described above, may be categorized as general rules, rules that deal with protection of the public, rules that deal with relations with other accountants, and rules that relate to the conduct of a professional practice.

Enforcement

The rules of conduct for chartered accountants are established and administered provincially. The rules of conduct for certified general accountants are promulgated by CGA-Canada. The provincial CGA associations have the power to add rules and have the responsibility for enforcing the rules. The rules of conduct for certified management accountants are promulgated and administered by the provincial societies.
The various professional bodies have the power to impose penalties ranging from public censure in the body’s newsletter, or requiring courses to be taken to upgrade skills, to levying fines or expulsion. As pointed out earlier, the three professional accounting bodies are self-regulating; that is, they have the responsibility for developing their own rules of conduct and for disciplining members who violate the rules. There is a danger that the public will perceive the disciplinary process as not being as stringent as it should be and that there is a reluctance to punish members who break the rules. One way this issue is being dealt with is by including laypersons on the disciplinary committees. A second approach is to make information available to the public about findings of the discipline committees and punishments meted out by them.

Unethical Behaviour—Is It Pervasive?

The headlines of The Globe and Mail, Report on Business blared the news—“Air Canada fined $1-million.” What would cause such a large fine? It’s called “insider trading,” and Air Canada was blatantly ignoring the law: The company had left voice-mail messages on the evening of October 5, 2000, warning some analysts that third and fourth quarter earnings would come in lower than expected. The next day, the stock fell 12 percent, however some institutional clients were able to act before the announcement of the lower earnings was made.

The newspaper also stated that auditors were to conduct a review of Air Canada’s disclosures over the next four quarters, and the results must be reported to the OSC (Ontario Securities Commission) and QSC (Quebec Securities Commission) as well as to the public.

The above situation is an example of inappropriate business ethics, and highlights the problems that arise when unethical behaviour takes place. If public accountants did not have a reputation for high-quality ethics, they would not be in a position to assist organizations like the OSC and the QSC.


ESSENTIAL TERMS

Audit committee — selected members of a client’s board of directors, who provide a forum for the auditors to remain independent of management (p. 71).
Client information — information communicated by a client to a professional (p. 73).
Confidential client information — client information that may not be disclosed without the specific consent of the client except under authoritative professional or legal investigation (p. 73).
Ethical dilemma — a situation in which a decision must be made about the appropriate behaviour (p. 61).
Ethics — a set of moral principles or values (p. 58).
Financial independence — not having a financial interest in the client (p. 69).
Independence — impartiality in performing professional services (p. 68).

Independence in appearance — the auditor’s ability to maintain an unbiased viewpoint in the eyes of others (p. 69).
Independence in fact — the auditor’s ability to take an unbiased viewpoint in the performance of professional services (p. 69).
Independence of mental attitude — an impartial mental attitude; an unbiased view of the client (p. 70).
Investigative independence — having the time and resources to obtain sufficient appropriate audit evidence (p. 70).
Reporting independence — reporting at a sufficiently high level that the report will be acted upon (p. 70).
Stakeholder — a person or group who has a stake in an organization’s or an individual’s activities (p. 62).
REVIEW QUESTIONS

3-1 Explain the need for a code of professional ethics for public accountants. In which ways should the public accountants’ code of ethics be similar to and different from that of other professional groups, such as lawyers or dentists?
3-2 List the three parts which normally comprise a code of professional conduct, and state the purpose of each.
3-3 What is meant by the statement, “The rules of professional conduct of a professional accounting organization should be regarded as a minimum standard”?
3-4 Distinguish between independence in fact and independence in appearance. State three activities that may not affect independence in fact but are likely to affect independence in appearance.
3-5 Why is an auditor’s independence so essential?
3-6 What are the four facets of independence discussed in the chapter? Explain why each is a necessary component of a public accountant’s independence.
3-7 Many people believe that a public accountant cannot be truly independent when payment of fees is dependent on the management of the client. Explain a way of reducing this appearance of lack of independence.
3-8 The auditor’s working papers usually can be provided to someone else only with the permission of the client. What is the rationale for such a rule?
3-9 The rules of conduct of CAs, CGAs, and CMAs require them to report a breach of the rules of conduct by a member to their profession’s disciplinary body. What should they do before making such a report?
3-10 After accepting an engagement, a public accountant discovers that the client’s industry is more technical than at first realized and that he or she (i.e., the accountant) is not competent in certain areas of the operation. What should the public accountant do in this situation?
3-11 Identify and explain factors that should keep the quality of audits high even though advertising and tendering are allowed.
3-12 Why do you think the rules of conduct of the professional accounting bodies which pertain to public accounting ban contingent fees for audits?
3-13 Why is it so important that a successor auditor communicate with the incumbent before accepting an appointment as auditor? What should the successor do if the incumbent doesn’t reply?

MULTIPLE CHOICE QUESTIONS

3-14 The following questions concern independence and the rules of professional conduct or GAAS. Choose the best response.

a. What is the meaning of the generally accepted auditing standard that requires the auditor to be independent?
   (1) The auditor must be without bias with respect to the client under audit.
   (2) The auditor’s sole obligation is to third parties.
   (3) The auditor may have a direct ownership interest in his or her client’s business if it is not material.
   (4) The auditor must adopt a critical attitude during the audit.

b. The independent audit is important to readers of financial statements because it
   (1) measures and communicates financial and business data included in financial statements.
   (2) determines the future stewardship of the management of the company whose financial statements are audited.
   (3) involves the objective examination of and reporting on management-prepared statements.
   (4) reports on the accuracy of all information in the financial statements.

3-15 The following questions concern possible violations of the rules of conduct discussed in the chapter. Choose the best response.

a. In which one of the following situations would a public accountant be in violation of the rules of conduct in determining his or her audit fee?
   (1) A fee equal to last year’s fee plus 10 percent.
   (2) A fee based on the nature of the service rendered and the public accountant’s particular expertise instead of the actual time spent on the engagement.
   (3) A fee based on whether the public accountant’s report on the client’s financial statements results in the approval of a bank loan.
   (4) A fee based on the fee charged by the prior auditor.

b. The rules of conduct state that a public accountant shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of his or her client. In which one of the situations given below would disclosure by a public accountant be in violation of the rules?
   (1) Disclosing confidential information in compliance with a subpoena issued by a court.
   (2) Disclosing confidential information to another accountant interested in purchasing the public accountant’s practice.
   (3) Disclosing confidential information in connection with a disciplinary hearing by the public accountant’s professional conduct committee.
   (4) Disclosing confidential information in order to properly discharge the public accountant’s responsibilities in accordance with his or her profession’s standards.
DISCUSSION QUESTIONS AND PROBLEMS

3-16 Trish Mulcahy, a new junior in your office, says that she doesn’t understand why she can’t work on the audit of a company that isn’t a client of your firm and that is owned by her uncle. Trish says she knows she must have an independent attitude and she will; her relationship to the owner is not important.

Required

What would you say in answer to her question? Would you let her work on the audit?

3-17 Each of the following scenarios involves a possible violation of the rules of conduct discussed in the chapter. Indicate whether each is a violation and explain why if you think it is.

a. John Brown is a public accountant, but not a partner, with three years of professional experience with Lyle and Lyle, Public Accountants, a one-office public accounting firm. He owns 25 shares of stock in an audit client of the firm, but he does not take part in the audit of the client and the amount of stock is not material in relation to his total wealth.

b. In preparing the corporate tax returns for a client, Phyllis Allen, public accountant, observed that the deductions for contributions and interest were unusually large. When she asked the client for backup information to support the deductions, she was told, “Ask me no questions, and I will tell you no lies.” Allen completed the return on the basis of the information acquired from the client.

c. A client requested assistance of Kim Tanabe, public accountant, in the installation of a computer system for maintaining production records. Tanabe had no experience in this type of work and no knowledge of the client’s production records, so he obtained assistance from a computer consultant. The consultant is not in the practice of public accounting, but Tanabe is confident of her professional skills. Because of the highly technical nature of the work, Tanabe is not able to review the consultant’s work.

d. Five small Moncton public accounting firms have become involved in an information project by taking part in an interfirm working paper review program. Under the program, each firm designates two partners to review the working papers, including the tax returns and the financial statements, of another public accounting firm taking part in the program. At the end of each review, the auditors who prepared the working papers and the reviewers have a conference to discuss the strengths and weaknesses of the audit. They do not obtain the authorization from the audit client before the review takes place.

e. James Thurgood, public accountant, stayed longer than he should have at the annual Christmas party of Thurgood and Thurgood, Public Accountants. On his way home, he drove through a red light and was stopped by a police officer, who observed that he was intoxicated. In a jury trial, Thurgood was found guilty of driving under the influence of alcohol. Since this was not his first offence, he was sentenced to 30 days in jail and his driver’s licence was revoked for one year.

f. Bill Wendal, public accountant, set up a casualty and fire insurance agency to complement his auditing and tax services. He does not use his own name on anything pertaining to the insurance agency and has a highly competent manager, Renate Jones, who runs it. Wendal frequently requests Jones to review with the management of an audit client the adequacy of the client’s insurance if it seems underinsured. He feels that he provides a valuable service to clients by informing them when they are underinsured.

g. Michelle Rankin, public accountant, provides tax services, management advisory services, and bookkeeping services and conducts audits for the same client. Since her firm is small, the same person frequently provides all the services.

3-18 Each of the following situations involves possible violations of the rules of conduct that apply to professional accountants discussed in the chapter. For each situation, state whether it is a violation of the rules as described. In those cases in which it is a violation, explain the nature of the violation and the rationale for the existing rule.

a. Mario Danielli is the partner on the audit of a charitable organization. He is also a member of the board of directors, but this position is honorary and does not involve performing a management function.

b. Fenn and Company, Public Accountants, has time available on a computer that it uses primarily for its own record keeping. Aware that the computer facilities of Delta Equipment Corp., one of Fenn’s audit clients, are inadequate for company needs, Fenn maintains on its computer certain routine accounting records for Delta.

c. Marie Godette, LLB, has a law practice. Godette has recommended one of her clients to Sean O’Doyle, public accountant. O’Doyle has agreed to pay Godette 10 percent of the fee O’Doyle receives from Godette’s client.

d. Theresa Barnes, CA, has an audit client, Choi, Inc., which uses another public accounting firm for management services work. Barnes sends her firm’s literature covering its management services capabilities to Choi on a monthly basis unsolicited.

e. A bank issued a notice to its depositors that it was being audited and requested them to comply with the public accounting firm’s effort to obtain a confirmation on the deposit balances. The bank printed the name and address of the public accounting firm in the notice. The public accounting firm has knowledge of the notice.

f. Wally Gutowski, a practicing public accountant, has written a tax article that is being published in a professional publication. The publication wishes to inform its readers about Gutowski’s background. The information,
which Gutowski has approved, includes his academic degrees, other articles he has had published in professional journals, and a statement that he is a tax expert.

g. Marcel Poust, public accountant, has sold his public accounting practice, which includes bookkeeping, tax services, and auditing, to Sheila Lyons, public accountant. Poust obtained permission from all audit clients for audit-related working papers before making them available to Lyons. He did not get permission before releasing tax- and management services-related working papers.

3-19   The *Canada Business Corporations Act* requires all companies incorporated under it to have audit committees.

Required

a. Describe an audit committee.

b. What are the typical functions performed by an audit committee?

c. Explain how an audit committee can help an auditor be more independent.

d. Your friend’s mother, who is chair of an audit committee of a large publicly traded company, knows that you are studying auditing and has asked you for advice on how she can make the audit committee she chairs more effective. Your response should consider both sides of each recommendation you make.

3-20   Diane Harris, public accountant, is the auditor of Fine Deal Furniture, Inc. In the course of her audit for the year ended December 31, 2001, she discovered that Fine Deal had serious going concern problems. Henri Fine, the owner of Fine Deal, asked Harris to delay completing her audit.

Harris is also the auditor of Master Furniture Builders Ltd., whose year end is January 31. The largest receivable on Master Furniture’s list of receivables is Fine Deal Furniture; the amount owing represents about 45 percent of Master Furniture’s total receivables, which in turn are 60 percent of Master Furniture’s net assets. The management of Master Furniture is not aware of Fine Deal’s problems and is certain the amount will be collected in full.

Master Furniture is in a hurry to get the January 31, 2002, audit finished because the company has made an application for a sizable loan from their bank to expand their operations. The bank has informally agreed to advance the funds based on draft financial statements submitted by Master Furniture just after the year end.

Required

What action should Harris take and why?

3-21   Marie Janes encounters the following situations in doing the audit of a large auto dealership. Janes is not a partner.

1. The sales manager tells her that there is a sale on new cars (at a substantial discount) that is limited to long-established customers of the dealership. Because her firm has been doing the audit for several years, the sales manager has decided that Janes should also be eligible for the discount.

2. The auto dealership has an executive lunchroom that is available free to employees above a certain level. The controller informs Janes that she can also eat there any time.

3. Janes is invited to and attends the company’s annual Christmas party. When presents are handed out, she is surprised to find herself included. The present has a value of approximately $200.

Required

a. Assuming Janes accepts the offer or gift in each situation, has she violated the rules of conduct?

b. Discuss what Janes should do in each situation.

3-22   The following are situations that may violate the general rules of conduct of professional accountants discussed in the chapter. Assume in each case that the public accountant is a partner.

1. Simone Able, public accountant, owns a substantial limited partnership interest in an apartment building. Juan Rodriguez is a 100 percent owner in Rodriguez Marine Ltd. Rodriguez also owns a substantial interest in the same limited partnership as Able. Able does the audit of Rodriguez Marine Ltd.

2. Horst Baker, public accountant, approaches a new audit client and tells the president that he has an idea that could result in a substantial tax refund in the prior year’s tax return by application of a technical provision in a tax law that the client had overlooked. Baker adds that the fee will be 50 percent of the tax refund after it has been resolved by Canada Customs and Revenue Agency. The client agrees to the proposal.

3. Chantal Contel, public accountant, advertises in the local paper that her firm does the audit of 14 of the 36 largest drugstores in the city. The advertisement also states that the average audit fee, as a percentage of total assets for the drugstores she audits, is lower than any other public accounting firm’s in the city.

4. Olaf Gustafson, public accountant, sets up a small loan company specializing in loans to business executives and small companies. Gustafson does not spend much time in the business because he works full time with his public accounting practice. No employees of Gustafson’s public accounting firm are involved in the small loan company.

5. Louise Elbert, public accountant, owns a material amount of stock in a mutual fund investment company, which in turn owns stock in Elbert’s largest audit client. Reading the investment company’s most recent financial report, Elbert is surprised to learn that the company’s ownership in her client has increased dramatically.

Required

Discuss whether the facts in any of the situations indicate violations of the rules of conduct for professional accountants discussed in the chapter. If so, identify the nature of the violation(s).
3-23 Gilbert and Bradley formed a corporation called Financial Services, Inc., each man taking 50 percent of the authorized common stock. Gilbert is a public accountant and a member of one of the professional accounting bodies in Canada. Bradley is a CFCU (Chartered Property Casualty Underwriter). The corporation performs auditing and tax services under Gilbert’s direction and insurance services under Bradley’s supervision. The opening of the corporation’s office was announced by an 8 cm, two-column “card” in the local newspaper.

One of the corporation’s first audit clients was Grandtime Corp. Grandtime had total assets of $600,000 and total liabilities of $270,000. In the course of his examination, Gilbert found that Grandtime’s building, with a book value of $240,000, was pledged as security for a 10-year term note in the amount of $200,000. The client’s statements did not mention that the building was pledged as security for the note. However, as the failure to disclose the lien did not affect either the value of the assets or the amount of the liabilities and his examination was satisfactory in all other respects, Gilbert rendered an unqualified opinion on Grandtime’s financial statements. About two months after the date of his opinion, Gilbert learned that an insurance company was planning to loan Grandtime $150,000 in the form of a first mortgage note on the building. Realizing that the insurance company was unaware of the existing lien on the building, Gilbert had Bradley notify the insurance company of the fact that Grandtime’s building was pledged as security for the term note.

Shortly after the events just described, Gilbert was charged with a violation of professional ethics.

**Required**

Identify and discuss the ethical implications of those acts by Gilbert that were in violation of the rules of conduct discussed in the chapter.

3-24 Barbara Whitley had great expectations about her future as she sat at her graduation ceremony in May 2000. She was about to receive her Masters of Accountancy degree, and the following week she would begin her career on the audit staff of Green, Thresher & Co., a public accounting firm. Things looked a little different to Barbara in February 2001. She was working on the audit of Delancey Fabrics Ltd., a textile manufacturer with a calendar year end. The pressure was enormous. Everyone on the audit team was putting in 70-hour weeks, and it still looked as if the audit wouldn’t be done on time. Barbara was doing work in the property area, vouching additions for the year. The audit program indicated that a sample of all items over $10,000 should be selected, plus a judgmental sample of smaller items. When Barbara went to take the sample, Jack Bean, the senior, had left the client’s office and couldn’t answer her questions about the appropriate size of the judgmental sample. Barbara forged ahead with her own judgment and selected 50 smaller items. Her basis for doing this was that there were about 250 such items, so 50 was a reasonably good proportion of such additions.

Barbara audited the additions with the following results: the items over $10,000 contained no errors; however, the 50 small items contained a large number of errors. In fact, when Barbara projected them to all such additions, the amount seemed quite significant.

A couple of days later, Jack Bean returned to the client’s office. Barbara brought her work to Jack in order to apprise him of the problems she found, and got the following response: “My God, Barbara, why did you do this? You were only supposed to look at the items over $10,000 plus 5 or 10 little ones. You’ve wasted a whole day on that work, and we can’t afford to spend any more time on it. I want you to throw the schedules where you tested the last 40 small items away and forget you ever did them.”

When Barbara asked about the possible audit adjustment regarding the small items, none of which arose from the first 10 items, Jack responded, “Don’t worry, it’s not material anyway. You just forget it; it’s my concern, not yours.”

**Required**

a. In what way is this an ethical dilemma for Barbara?

b. Use the six-step approach discussed in the book to resolve the ethical dilemma.

3-25 In 1995, Giles Nadeau was a bright, upcoming audit manager in the Winnipeg office of a national public accounting firm. He was an excellent technician and a good “people person.” Giles also was able to bring new business into the firm as the result of his contacts in the francophone business community.

Giles was assigned a new client in 1996, XYZ Securities, Inc., a privately held broker-dealer in the secondary market for Canadian government securities. Neither Giles nor anyone else in the Winnipeg office had broker-dealer audit experience. However, Giles was able to obtain audit aids for the industry from his firm’s national office, which he used to get started.

Giles was promoted to partner in 1997. Although this was a great step forward for him (he was a new staff assistant in 1987), Giles was also under a great deal of pressure. Upon making partner, he was required to contribute capital to the firm. He also felt he must maintain a special image with his firm, his clients, and within the francophone community. To accomplish this, Giles maintained an impressive wardrobe, bought a Cadillac Seville and a small speedboat, and traded up to a nicer house. He also entertained freely. Giles financed much of this higher living with credit cards. He had American Express, Diners Club, en Route, and Visa cards and ran up a balance of about $40,000.

After the audit was completed and before the 1998 audit was to begin, Giles contacted Lynda Oakes, the CFO of XYZ Securities, with a question. Giles had noticed an anomaly in the financial statements that he couldn’t understand and asked Oakes for an explanation. Lynda’s reply was as follows: “Giles, the 1997 financial statements were materially misstated and you guys just blew it. I thought you might realize this and call me, so here’s my advice to you. Keep your mouth shut. We’ll make up this year the loss we cov-
ered up last year, and nobody will ever know the difference. If you blow the whistle on us, your firm will know you screwed up, and your career as the star in the office will be down the tubes.”

Giles said he’d think about this and get back to Lynda the next day. When Giles called Lynda, he had decided to go along with her. After all, it would only be a “shift” of a loss between two adjacent years. XYZ is a private company and no one would be hurt or know the difference. In reality, he was the only person exposed to any harm in this situation, and he had to protect himself, didn’t he?

When Giles went to XYZ to plan for the 1998 audit, he asked Lynda how things were going and she assured him they were fine. He then said to Oakes, “Lynda, you guys are in the money business. Maybe you can give me some advice. I’ve run up some debts and I need to refinance them. How should I go about it?”

After some discussions, Lynda volunteered a “plan.” She would give Giles a cheque for $15,000. XYZ would request its bank to put $60,000 in an account in Giles’s name and guarantee the loan security on it. Giles would pay back the $15,000 and have $45,000 of refinancing. Giles thought the plan was great and obtained Lynda’s cheque for $15,000.

During 1998 through 2000, three things happened. First, Giles incurred more debts and went back to the well at XYZ. By the end of 2000, he had “borrowed” a total of $125,000. Second, the company continued to lose money in various “off-the-books” investment schemes. These losses were covered up by falsifying the results of normal operations. Third, the audit team, under Giles’s leadership, “failed to find” the frauds and issued unqualified opinions.

In 2000, Lynda had a tax audit of her personal 1999 return. She asked Giles’s firm to handle it, and the job was assigned to Bob Smith, a tax manager. In reviewing Lynda’s records, Smith found a $15,000 cheque payable from Oakes to Nadeau. Smith asked to see Nadeau and inquired about the cheque. Giles somewhat broke down and confided in Smith about his problems. Smith responded by saying, “Don’t worry Giles, I understand. And believe me, I’ll never tell a soul.”

In 2000, XYZ’s continuing losses caused it to be unable to deliver nonexistent securities when requested by a customer. This led to an investigation and bankruptcy by XYZ. Losses totalled in the millions. Giles’s firm was held liable, and Giles was found guilty of conspiracy to defraud. He is still in prison today.

**Required**

a. Try and put yourself in Giles Nadeau’s shoes. What would you have done (be honest with yourself) when told of the material misstatement in the 1997 financial statements?

b. What do you think of Bob Smith’s actions to help Giles?

c. Where does one draw the line between ethical and unethical behaviour in the situations described in this case study?