



**Code of Ethics: Case studies for PAIB and PAIP**

The *Code of Ethics for Professional Accountants* (Code) applies to all Institute members. Chapter A of the Code is based on the International Ethics Standards Board for Accountants’ (IESBA) *International Code of Ethics for Professional Accountants (Including Standards)*. It is underpinned by the five fundamental principles that establish the standard of behaviour expected of a professional accountant. They are:

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional behaviour

The Code also requires professional accountants in public practice to be independent when performing audits, reviews, or other assurance engagements. Independence is closely linked to the principles of integrity and objectivity and is an important element of serving the public interest.

Paragraph 10 of the preface of the Code states that “Council requires members of the Institute to comply with the Code. Apparent failures by members of the Institute to comply with the Code are liable to be enquired into by the appropriate committee established under the authority of the Institute, and disciplinary action may result...” Disciplinary action may include:

- Temporary or permanent removal from membership
- Temporary or permanent cancellation of a practising certificate issued to a CPA
- Reprimand
- Penalty of up to HK\$500,000
- Payment of costs and expenses of proceedings

The following case studies were developed by the Institute’s Ethics Committee. They illustrate breaches to the fundamental principles of the Code by professional accountants and are adapted from the real-life cases involving Institute members. These scenarios illustrate the fundamental principles in the Code, but are not intended to cover every possible circumstance. Where appropriate, additional case studies would be developed to raise the awareness of certain ethical topics and corresponding requirements in the Code.

Case study	Title	Intended audiences*
Case 1	Sales of trust assets (September 2021)	PAIB
Case 2	Engagement quality control reviewer (September 2021)	PAIP

\*PAIB = Professional accountants in business  
 PAIP = Professional accountants in practice

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**Case 1: Sales of trust assets**

*Intended audiences: Professional accountants in business*

- In 2014, Peter became the sole director of ABC Limited. He also became the sole registered shareholder of the company for the benefit of the beneficial owner of ABC Limited who is a separate legal person.
- The company held shares in a Hong Kong listed company (“shares”), XYZ International Limited. On 18 September 2015, the shares’ market value was HK\$140 million.
- On 18 September 2015,
  - Peter facilitated ABC Limited to sell the shares to a buyer at 40% of the closing price on the day immediately before.
  - A HK\$5 million cheque was drawn by the buyer to ABC Limited as part of the purchase consideration, but Peter never cashed it. The terms of the sale were to be completed seven days later. There was no security for the payment other than a deposit of HK\$5 million.
  - The disposal of shares was without the consent, knowledge or instructions of the beneficial owner of ABC Limited.
- Peter claimed that the poor annual results published by XYZ International Limited on 18 September were an impetus for selling the shares. He considered the sales of shares was in the best interest of ABC Limited, the beneficial owner and himself.
- Peter signed the “sold notes” of the shares which stated that the sales were for full market value and that the consideration had been received, in the knowledge that this was untrue. These notes would be provided to the Inland Revenue Department for stamp duty purposes.

***Consider the following with reference to the Code:***

- 1. Which fundamental principles did Peter fail to comply with?***
- 2. Was it appropriate for Peter to sell the shares in the manner described in the case? Why or why not?***
- 3. Peter asserted that there was no breach of the fundamental principles with regard to the sold notes for stamp duty purposes. He argued that there would only be falsity if it involved understating the consideration, but there would not be falsity in overstating the consideration and paying more stamp duty. Do you agree?***



*Peter failed to comply with the fundamental principles of **professional behaviour** and **integrity**.*

- **Professional behaviour**

- Peter failed to uphold the fiduciary duties to the beneficial owner of ABC Limited under the relevant laws (i.e. the common law) to act in the best interests of the company. He sold the shares at a substantial discount of the market price and executed the sales without security other than a deposit of HK\$5 million. Also, he disposed of 100% of the shares without any prior consent from the beneficial owner.
- The Institute's Disciplinary Committee, when considering the facts and circumstances in the given scenario, summarized in its disciplinary decision that it is untenable that the respondent (i.e. Peter) would consider that it was in the company's best interests to sell the shares at a 60% discount without first selling the shares on the market; it is unbelievable that the respondent would consider it to be in the company's best interests to execute the sales without any security other than a deposit for HK\$5 million.
- Peter made false statements in the sold notes to the shares that the sales were for full market value and that consideration had been received, which was not true. They were false statements regardless of whether the consideration was more or less than the actual amount. The fact that Peter had not defrauded upon the amount of the stamp duty to levy is irrelevant regarding whether there was a breach to the fundamental principles.

- **Integrity**

- Peter acted dishonestly and caused ABC Limited to mislead the Inland Revenue Department by signing the sold notes showing incorrect sales proceeds, and by knowingly participating in a transaction which involved the misapplication of trust assets to the detriment of the beneficial owner.

***What does the Code say?***

Paragraph R115.1 in Chapter A requires Institute members to comply with the principle of professional behaviour, i.e. to comply with relevant laws and regulations; behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; not perform any action that would discredit the profession.

The Code also requires members to act with integrity, i.e. to be straightforward and honest in all professional and business relationships (paragraph R111.1 in Chapter A). The Code describes integrity as involving fair dealing, truthfulness and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organizational consequences (paragraph 111.1 A1 in Chapter A).



**What should Peter have done?**

Peter should have:

- Obtain prior consent from the beneficial owner before disposing the shares.
- Act in the interest of ABC Limited. This includes but is not limited to assessing threats to compliance with the fundamental principles by exercising professional judgement and taking into account whether **a reasonable and informed third party** would be likely to conclude that it would be in ABC Limited's best interests to:
  - Sell the shares at a 60% discount instead of selling them on the market; and
  - Execute the sale without any security other than a deposit for HK\$5 million.
- Act honestly, including but not limited to, stating the actual price for the sale of shares in the sold notes.



**Case 2: Engagement quality control reviewer**

*Intended audiences: Professional accountants in public practice*

John was the sole proprietor of a firm and the engagement partner of DEF Limited, a Hong Kong listed company. The firm audited the consolidated financial statements of DEF Limited for the year ended 31 December 2018 and expressed an unmodified auditor's opinion thereto. Arthur was the engagement quality reviewer (EQR) of the audit.

During 2018, DEF Limited entered into a sale transaction which allowed the buyer to settle the payment by interest-free instalments over a period of 20 years. DEF Limited recognized the revenue and trade receivable of the transaction at the invoiced amount without taking into account the discounting effect of the transaction.

DEF Limited had two overseas subsidiaries that were a substantial portion of the net assets of the group. The overseas subsidiaries were audited by a local branch of an international accountancy firm ("the overseas auditor").

During the audit:

- The firm did not identify the company's non-compliance with the relevant accounting standard on the treatment of the transaction.
- The audit documentation did not contain evidence that John had discussed significant matters of the audit, in particular the discounting effect of the transaction, with Arthur.
- In response to the firm's group audit instructions, the overseas auditor provided the firm a summary of audit procedures performed on the overseas subsidiaries and the corresponding findings.
- As John was simultaneously working on multiple engagements and work commitments, he requested Arthur to consider and review the overseas auditor's summary of work and findings, without first evaluating them himself as the engagement partner. At John's request, Arthur recorded his review and conclusion with respect to the overseas auditor's work in a working paper and reported his findings to John.
- John considered Arthur's review of the overseas auditor's work and findings to be part of Arthur's work as an EQR to review significant judgements made, as opposed to the responsibilities of the engagement team.
- John asserted that the independence of Arthur from the engagement team could be assured because the overseas subsidiaries had been audited by a "big four" accountancy firm.



*Consider the following with reference to the Code:*

- 1. Which fundamental principles did John and Arthur fail to comply with?*
- 2. What were the deficiencies committed by John and Arthur in carrying out the audit engagement?*
- 3. Do you agree with John that Arthur's review of the overseas auditor's work and findings was part of the work of an EQR? Why or why not?*
- 4. Do you agree with John's explanation that Arthur's independence as an EQR could be assured? Why or why not?*

**John and Arthur** had breached the fundamental principle of **professional competence and due care** as well as **the independence requirements**.

- They failed to identify the accounting non-compliance of DEF Limited's consolidated financial statements but expressed an unmodified auditor's opinion, which might have a bearing on users of the audited financial statements.
  - **John** failed to challenge the appropriateness of the accounting treatment of the transaction with a sceptical mind and evaluate whether accounting estimates pertaining to the transaction were reasonable in the context of the applicable financial reporting framework and perform adequate audit procedures thereof. The investigation also noted that John did not communicate to the audit committee his views on the qualitative aspects of the transaction, which involved significant judgement and estimation.
  - **Arthur** failed to act competently and diligently, i.e. he did not objectively evaluate the significant judgements made and the conclusions reached by the engagement team in the capacity of an EQR.
- Arthur violated the independence and objectivity of an EQR by reviewing the audit work and findings by the overseas auditor. This involved significant judgements and was an integral part of the audit procedures to be carried out by the engagement team in a group audit, being far more extensive than an evaluation by an EQR. Consequently, this gave rise to a self-review threat because Arthur involved in the significant judgements made in the audit engagement that were subsequently reviewed by him in the capacity of an EQR.
- John's view of the role and responsibilities of the engagement team and EQR in a group audit engagement demonstrates his lack of understanding of the relevant requirements. He failed to ensure that the work required for a group audit engagement was properly performed. He also failed to ensure the EQR was independent from the audit engagement team.

***What does the Code say?***

According to paragraph R113.1 in Chapter A, a professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to:

- (a) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
- (b) Act diligently and in accordance with applicable technical and professional standards.



### ***What do the professional standards say?***

Paragraph 40 of HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* requires a firm to establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Paragraph A49 continues that such policies and procedures provide that the engagement quality control reviewer:

- Where practicable, is not selected by the engagement partner;
- Does not otherwise participate in the engagement during the period of review;
- Does not make decisions for the engagement team; and
- Is not subject to other considerations that would threaten the reviewer's objectivity.

HKSQM 2 *Engagement Quality Reviews* is effective for audits and reviews of financial statements for periods beginning on or after 15 December 2022, and effective for other assurance and related services engagements beginning on or after 15 December 2022. When HKSQM 2 becomes effective, it replaces the extant provisions relating to engagement quality reviews in extant HKSQC 1 and HKSA 220 *Quality Control for an Audit of Financial Statements*

- According to paragraph 9 of HKSQM 2, the EQR is not a member of the engagement team. The performance of an engagement quality review does not change the responsibilities of the engagement partner for managing and achieving quality on the engagement, or for the direction and supervision of the members of the engagement team and the review of their work. ***The EQR is not required to obtain evidence to support the opinion or conclusion on the engagement, but the engagement team may obtain further evidence in responding to matters raised during the engagement quality review.***
- According to paragraph 13(a) of HKSQM 2, ***an engagement quality review is an objective evaluation of the significant judgements made by the engagement team and the conclusions reached thereon***, performed by the EQR and completed on or before the date of the engagement report.
- According to paragraph A14 of HKSQM 2, ***a self-review threat may be created when the EQR previously was involved with significant judgements made by the engagement team, in particular as the engagement partner or other engagement team member.***

### **What should John have done?**

John, as the engagement partner, should have:

- Determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the audit engagement, the firm's policies or procedures, and any changes that may arise during the engagement (paragraph 25 of HKSA 220 (Revised)<sup>1</sup>).

<sup>1</sup> HKSA 220 (Revised) *Quality Management for an Audit of Financial Statements* replaces HKSA 220. It is effective for audits of financial statements for periods beginning on or after 15 December 2022.





- Take reasonable steps to ensure members of the engagement team collectively have the appropriate competence and capabilities to perform the audit engagement (paragraph 26 of HKSA 220 (Revised)).
- Apply professional knowledge and skill with sound judgement and professional skepticism, including the application of HKSA 540 (Revised)<sup>2</sup> in auditing accounting estimates and requirements in HKSA 600<sup>3</sup> with respect to a group audit engagement.
- Ensure relevant ethical requirements including those relating to independence have been fulfilled (paragraph 21 of HKSA 220 (Revised)).
- Determine that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued, through review of audit documentation and discussion with the engagement team (paragraph 32 of HKSA 220 (Revised)).
- Ensure a consultation is undertaken on difficult or contentious matters (paragraph 35(a) of HKSA 220 (Revised)), such as the accounting treatment of the transaction.
- Ensure that significant matters and significant judgements arising during the audit engagement are discussed with the EQR (paragraph 36(c) of HKSA 220 (Revised)).
- Communicate the auditor's views about significant qualitative aspects of the entity's accounting practices and significant matters arising during the audit with those charged with governance (paragraph 16 of HKSA 260 (Revised)<sup>4</sup>).

### **What should Arthur have done?**

Arthur, as an EQR, should have:

- Apply the conceptual framework of the Code to identify, evaluate and address threats to his independence and objectivity as an EQR.
- Act competently and diligently as an EQR in accordance with the relevant professional requirements, including but not limited to:
  - Notifying the appropriate individual in the firm when he becomes aware of circumstances that impair the EQR's eligibility (paragraph 23 of HKSQM 2).
  - Discussing with the engagement partner and other members of the engagement team significant matters and significant judgements made in planning, performing and reporting the engagement (paragraph 25(b) of HKSQM 2).
  - Evaluating the basis for the engagement partner's determination that relevant ethical requirements relating to independence have been fulfilled (paragraph 25(d) of HKSQM 2).

<sup>2</sup> HKSA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* replaces HKSA 540. It is effective for audits of financial statements for periods beginning on or after 15 December 2019.

<sup>3</sup> HKSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Works of Component Auditors)*

<sup>4</sup> HKSA 260 (Revised) *Communication with Those Charged with Governance*



- Evaluating whether the engagement partner's involvement was sufficient and appropriate throughout the audit engagement to provide the basis for significant judgements made and the conclusions reached (paragraph 25(f) of HKSQM 2).