

# Ethics in Management

A Practical Guide  
for Professional Accountants

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A Joint Publication of  
Hong Kong Ethics Development Centre &  
Hong Kong Society of Accountants



# Ethics in Management

A Practical Guide  
for Professional Accountants

*This title is jointly published by the Hong Kong Society of Accountants (HKSA) and the Hong Kong Ethics Development Centre (HKEDC).*

*This publication aims to provide general guidance only and does not purport to deal with all possible questions and issues that may arise in any given situation. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can therefore be accepted by the HKSA, the HKEDC or HKSA members who provided their commentaries on the case studies.*

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*December 1997 First Edition*

# Message from the President of the Hong Kong Society of Accountants

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One of the distinguishing features of a profession such as the accountancy profession is the adherence by its members to a common code of values and conduct established by its administrative body, including maintaining an outlook which is essentially objective. In addition, as membership of a profession is usually restrictive and certain activities (such as statutory audit, for example) are reserved to members of the profession, there must be acceptance of a general duty to society as a whole.

There are, however, occasions where duty to their profession and to society as a whole may seem to be in conflict with their immediate self interest or their duty of loyalty to their employers. When faced with these potential conflicts, professional accountants who are members of the Hong Kong Society of Accountants (HKSA) will refer to the HKSA ethical codes for guidance.

In addition to the ethical codes, it is felt that certain practical guidance on how to deal with ethical problems which may be encountered in the workplace may also be useful to HKSA members. Accordingly, the HKSA entered into discussion with the Hong Kong Ethics Development Centre (HKEDC) of the Independent Commission Against Corruption in 1996 on the development of this practical guide. It is hoped that this practical guide will become a resource to be used by HKSA members. The HKEDC is an ideal partner of the HKSA in this project as the HKEDC and HKSA have successfully co-organised four seminars "Achieve Excellence by Integrity : Corruption and Fraud Prevention" in the past two years.

On behalf of the HKSA, I wish to convey my sincere gratitude and warm congratulations to the members of the Publication Drafting and Design Team who have rendered so much effort and contribution to this project.

Finally, I would like to take this opportunity of thanking those HKSA members who responded to the HKSA survey aiming to identify those areas of most concern to provide a focus for this practical guide by completing and returning the questionnaire to the HKSA.



---

Tim T.L. LUI  
President  
Hong Kong Society of Accountants

# Message from the Chairman of the Hong Kong Ethics Development Advisory Committee

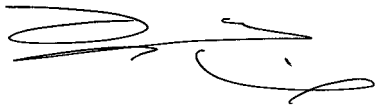
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Over the past two decades, Hong Kong has established itself as an international financial and business centre and one of the cleanest and most efficient places to do business. While the community at large are glad to find that the Independent Commission Against Corruption (ICAC) has kept corruption under control, the ICAC is still alive to public worries that corruption and corruption-related fraud will lower business standards of the economy and undermine Hong Kong's competitiveness.

Everyone will agree that a community with high ethical standard is more resistant to corruption, especially when legislative controls are reactive and remedial in nature. It is against such a background that the ICAC launched the landmark conference on business ethics together with the leading chambers of commerce in May 1994 to promote high business standard in Hong Kong. The Hong Kong Ethics Development Centre (HKEDC) was established under the auspices of the ICAC thereafter with the task of promoting business and related ethics on a long term basis.

In the past few years, the HKEDC and the Hong Kong Society of Accountants (HKSA) have been working closely in promoting a high ethical standard in the profession. In this joint publication, we aim to address the ethical issues encountered in the accountancy profession and to provide an in-depth yet handy reference on how to handle these issues properly and, at the same time, ethically. Parallel to these, professional accountants are also reminded of their important roles in corruption and fraud prevention which is part and parcel of ethical management.

Needless to say, in the promotion of ethics and corruption prevention, concerted effort and support of members of the accountancy profession are essential. The HKEDC is ready to work shoulder to shoulder with members of the HKSA towards this common goal. We are always ready to offer advice and consultancy service to all professional accountants to put ethics into practice.



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*Herbert LIANG, M.B.E.  
Chairman  
Hong Kong Ethics Development Advisory Committee*

*December 1997*

# Acknowledgements

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*\*The HKEDC is a non-profit-making body formed under the auspices of the Community Relations Department of the ICAC.*

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# TABLE OF CONTENTS

*Message from the President of the Hong Kong Society of Accountants*    *iii*

*Message from the Chairman of the Hong Kong Ethics Development  
Advisory Committee*    *iv*

*Acknowledgements*    *v*

*Definitions*    *ix*

## CHAPTER ONE THE ACCOUNTANCY PROFESSION

- Role of professional accountants    3
- Why should professional accountants abide by a high ethical standard?    4
- HKSA's code of professional ethics : Fundamental Principles    5
- How to apply the Fundamental Principles?    6

## CHAPTER TWO THE ETHICAL DIMENSION OF THE ACCOUNTANCY PROFESSION

- Ethical pressures faced by professional accountants    13
- HKSA's survey on common ethical issues faced by professional accountants    14

## CHAPTER THREE ETHICAL DECISION MAKING

- ETHICS PLUS decision making model    21
- Case studies    27

8            9            ÷

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**CHAPTER FOUR ETHICAL MANAGEMENT -  
CORRUPTION AND FRAUD PREVENTION**

- The current corruption and fraud scene 41
- Red flags from ICAC cases 41
- Professional accountants' responsibilities for the prevention of corruption and fraud 43
- Disclosure of defaults or unlawful acts by professional accountants 51

**CHAPTER FIVE SERVICES AND ASSISTANCE**

- Hong Kong Society of Accountants 55
- Hong Kong Ethics Development Centre 56

**REFERENCES & APPENDICES**

- References 60
- Appendix I : HKSA's survey findings 62
- Appendix II: Extracts of the Prevention of Bribery Ordinance and the Theft Ordinance 65
- Appendix III: Worksheet for analysing the cases by ETHICS PLUS Model 70

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# Definitions

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**Ethics** - encompasses the system of beliefs that supports a particular view of morality. (Hosmer, 1991) Ethics involves the study of the tendency to do right or wrong, or ..... beliefs about what's right and wrong, good and bad. (Martin, 1991)

**Morality** - refers to the standards of behaviour by which people are judged and particularly to the standards of behaviour by which people are judged in their relationships with others. (Hosmer, 1991)

**Professional Accountant** - means a person who is registered as a professional accountant under section 22 of the Professional Accountants Ordinance.

*Throughout this booklet, the male pronoun is used to cover references to both the male and female.*

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# Chapter 1

## THE ACCOUNTANCY PROFESSION

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*"The standing, if not the very existence of a profession depends on the continuance of public confidence in the standard of its members and the professional ethics of accountancy exist to serve and develop that confidence". (Barradell, 1969)*

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"Can we serve two clients with competing interests at the same time?"

"Who really is our client?"

"Can we provide consulting service to the client we audit as well?"

These are just a few of the many ethical problems that professional accountants may encounter. Such issues, however, cannot be handled in an ethically responsible manner unless professional accountants have a clear understanding of their roles, obligations, the standards of behaviour expected of them by the public and the judgements and values needed to reflect such standards.

## Role of Professional Accountants

The role of professional accountants is manifested in the various areas of service they provide, for example :

- accounting and reporting principles, practices and systems
- auditing of accounting records, systems and financial statements
- financial projections : preparation, analysis and audit
- taxation : preparation of tax returns and advice
- bankruptcy : trustee's duties and advice
- financial planning : advice
- decision making : facilitation through analysis and approach
- management control : advice and design of systems
- corporate and commercial affairs : advice

*(Brooks, 1995)*

## Why Should Professional Accountants Abide by a High Ethical Standard?

With these distinct roles, professional accountants have the responsibilities and obligations to abide by a high ethical standard as :

- professional accountants in public practice, i.e. certified public accountants (CPAs) must have the confidence of not only those who become their clients, but also the confidence of the general public. As clients of CPAs do not have the expertise to evaluate the performance of the CPAs, public confidence in the quality of professional service is enhanced only if the accountancy profession encourages high standards of performance and conduct on the part of all professional accountants.
- the judgement and behaviour of a CPA may have an impact on the economic well-being of the community as a whole. Thus the role of the CPA as an independent auditor is indeed unique in its demand for ethical standards and objectivity.
- a good professional is also a good manager. Adherence to professional ethics by professional accountants not only enhances the power of self-regulation in the accountancy profession itself, but also lessens the demand for more government regulation. Having achieved consistency in all dealings, professional accountants can thus ensure autonomy as well as high efficiency without the constraints imposed by others.
- it is of little doubt that the public will search for professional accountants who not only demonstrate high technical competence but also a high ethical standard. In the midst of keen competition in the profession, professional accountants who possess good judgement and credible reputations are certainly occupying an advantageous position. A high standard of ethics is

therefore one of the key attributes which makes accountancy such an important profession.

- as pointed out by L.J. Brooks, the mastery of accounting or audit technique is certainly not the critical value-added by professional accountants. Rather the critical value-added "lies in the expectation that whatever services are offered will be based on integrity and objectivity and these values, in addition to an ensured minimum standard of competence, lend credibility to the report or activity". (Brooks, 1995)

## HKSA's Code of Professional Ethics: Fundamental Principles

To ensure the highest quality of performance and to maintain public confidence in the accountancy profession, the HKSA has laid down ethical codes that set standards of conduct and provide guidance for professional accountants.

In particular, the HKSA Statement 1.200, which describes the duties and obligations of the members of the profession, whether in public practice or not, contains the Fundamental Principles.

The following are the Fundamental Principles on which the ethical guidance of the HKSA is based :

- In accepting or continuing a professional assignment or occupation a professional accountant should always have regard to any factors which might reflect adversely upon his integrity and objectivity in relation to that assignment or occupation.
- A professional accountant should carry out his professional work with a

proper regard for the technical and professional standards expected of him as a professional accountant and should not undertake or continue professional work which he is not himself competent to perform unless he obtains such advice and assistance as will enable him competently to carry out his task.

- A professional accountant should conduct himself with courtesy and consideration towards all with whom he comes into contact in the course of his professional work.
- A professional accountant should follow the ethical guidance of the Society and in circumstances not provided for by that guidance should conduct himself in a manner consistent with the good reputation of the profession and the Society.

## How to Apply the Fundamental Principles?

While the Fundamental Principles are framed in broad and general terms and constitute basic advice on professional behaviour, the HKSA Professional Ethics Statements provide more detailed information as to what is expected of a professional accountant in certain circumstances.

### Integrity and objectivity

- Integrity ensures that the services provided by professional accountants will be performed honestly and fairly. The principle of objectivity imposes the obligation on all professional accountants to be fair, honest and free from bias and conflicts of interest.
- Whether the professional accountants are undertaking reporting assignments, rendering tax and management advisory services, preparing financial statements or performing internal auditing services, they should uphold integrity of their professional services and maintain objectivity in their judgement.



- To maintain high independence and objectivity, professional accountants should watch out for situations such as:
  - 1) provision of management consulting and audit services to the same client;
  - 2) performance of accountancy and audit work by the same staff;
  - 3) engagement in audit assignments for the same client by the same senior staff over a number of years ;
  - 4) handling of pressure from "big" clients to give in to their requests;
  - 5) fees - undue dependence on a client; and
  - 6) excessive entertaining to obtain and maintain clients.

## Conflicts of interest

- From time to time professional accountants encounter conflicts of interest which may range from relatively trivial dilemmas to extreme cases of corruption and fraudulent activities. Professional accountants should be constantly alert to situations such as:
  - 1) owning equity of the client;
  - 2) owing money to or being owed money by a client;
  - 3) serving as auditors of businesses of close friends and business associates; and
  - 4) advising clients to use products or services provided by a company in which the professional accountant has a substantial interest.

## Professional competence

- Professional competence includes two separate phases :
  - 1) attainment of professional competence through specific education and training in professionally relevant subjects; and
  - 2) maintenance of professional competence requires a continuing professional education and awareness of developments in the accountancy profession including relevant Hong Kong and international pronouncements on accounting, auditing and other relevant regulations and statutory requirements.
- Professional accountants should uphold a high quality of service at all times and should be careful to ensure this in situations such as the following:
  - 1) client's short notice of a very tight tax deadline;
  - 2) unreasonably low fee quotations in order to gain new business or retain old clients; and
  - 3) accepting an assignment which requires special technical competence of the professional accountants.

## Confidentiality

- Professional accountants have an obligation to respect the confidentiality of information in respect of a client's or employer's affairs acquired in the course of professional services.
- Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.

- Professional accountants should neither use nor appear to use the information acquired in the course of performing professional services for personal advantage or for the advantage of a third party.
- To avoid breaching confidentiality, professional accountants should be on the alert for situations such as:
  - 1) drawing the line between sharing general "industry" knowledge within the firm and with other clients, and keeping client information confidential;  
and
  - 2) distinguishing between experience gained in previous employment and confidential information acquired there.

# Chapter 2

## THE ETHICAL DIMENSION OF THE ACCOUNTANCY PROFESSION

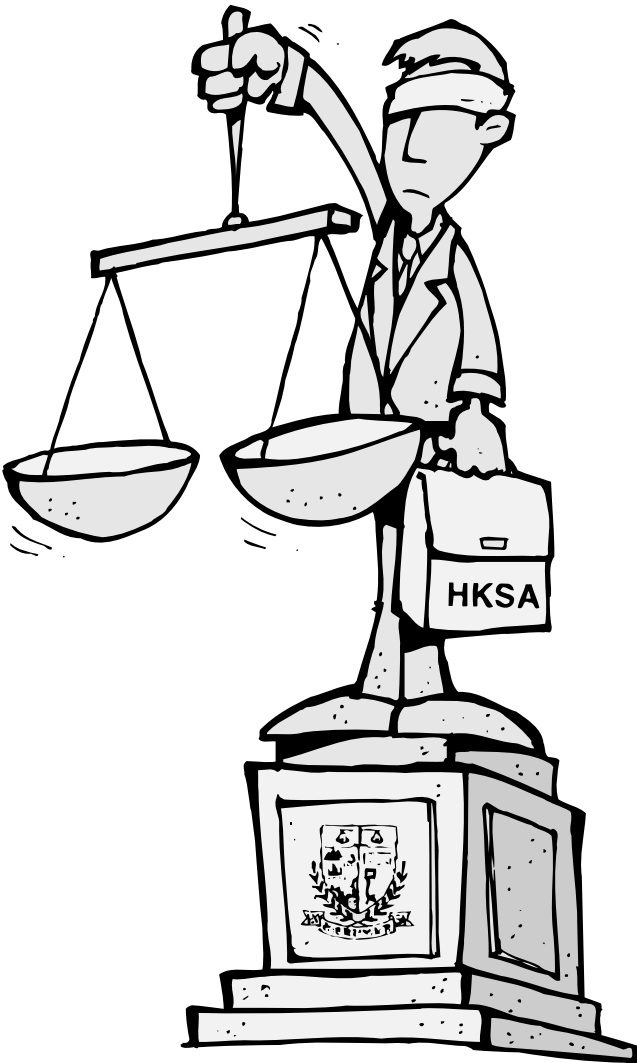
*"How do accounting professionals reconcile conflicting moral duties? In a fundamental sense, we can say that in practice they often do not. It is part and parcel of all professional activity to face ethical dilemmas and to experience rights and duties in conflict". (Cottell Jr and Perlin, 1990)*

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## **Ethical Pressures Faced by Professional Accountants**

"As business transactions have increased in complexity, so have ethical issues in accounting". (Loeb, 1989) In fact, changes in the structure of the business have added pressures on professional accountants. Robert J. Sack, a leading American accountant who headed the Enforcement Division of the powerful US Securities and Exchange Commission, identified the following four main pressures faced by professional accountants.

### **1) Commercialization**

The growing tendency of accounting firms to rely on income from non-audit sources like management advising and tax preparation may exert pressure on firms to compromise auditing standards in order to win more business in non-audit areas.

### **2) Opinion shopping**

Opinion shopping by clients to seek advice from professional accountants who will give favourable financial reports is another source of pressure. A rival firm being asked for a second opinion may give a more liberal view on a controversial matter in the hope of procuring the audit while the auditor is then persuaded to accept this alternative for fear of losing the audit.

### **3) Searching for loopholes in financial, securities and tax rules**

Since accounting and finance are dynamic disciplines, there will always be situations that are not covered in the existing written standards. Professional accountants might be urged to devise transactions that obtain the intended result while ostensibly avoiding the adverse effects of the written standards or even to devise transactions that appear to comply with the written standards but actually run contrary to their spirit.

#### **4) Preparing financial statements for growing companies**

Some companies want to "invent success and create sales when there are none in an effort to capitalize on the market's hunger for ground-floor opportunities". (Sack, 1985) The auditors may face the pressure of being asked to simply accept the word of management for something that normally requires independent verification.

## **HKSA's Survey on Common Ethical Issues Faced by Professional Accountants**

In April 1997, the HKSA conducted a survey to gauge up-to-date views from its 12,000 members on the most common ethical issues they might encounter in their workplace. Over 1,200 members, comprising practising and non-practising members, returned the questionnaire. The survey findings are attached in Appendix I.

### **1) Non-Practising Sector**

As non-practising professional accountants are mostly managers in organisations, they play dual roles as both a professional and a manager. While performing diversified functions, ranging from accounting, budgetary control, tax planning and preparation of financial data which are mainly professional duties, to fraud detection and prevention, system control and staff management which are important responsibilities of managers, professional accountants in the non-practising sector have to face more challenges as well as to deal with more ethical dilemmas in the workplace.

## Summary of the Survey Findings

### A) Coping with superiors' instructions to carry out unethical acts

The findings revealed that three of the top five most common ethical issues concerned "coping with superiors' instructions to carry out unethical acts".

The pressure from superiors to project the desired financial performance to the outside world was regarded as the most common ethical issue. This reflected the difficulty of an employee to remain ethical when top management or the organisation culture did not permit him to do so. Instructions to provide inflated management accounting data and pressure from superiors to pass their private or illegitimate business expenses through the accounts of the organisation were ranked as the third and fourth ethical concern.

Respondents also had to face superiors' pressure in dealing with customers who had a history of bad credit but had close relation with the senior management. In addition, the pressure to offer advantages as facilitating payments was another ethical issue to handle.

In general, respondents pointed out thought-provoking ethical issues which many non-practising professional accountants were facing: should one compromise one's professional and ethical standards to carry out unethical acts when instructed by superiors or uphold one's professional and ethical standards by refusing to carry out superiors' instructions but run the risk of losing one's job? Should one blow the whistle to report the fraudulent activities of senior management to the authorities? Should one leak employees' corruption or other fraudulent acts to external auditors without authorisation by management?

It is also worth noting that some problems, e.g. making facilitating payments or processing illegitimate expenses, involved not only ethical dimensions but also had legal implications.



## **B) Use of confidential information**

Apart from pressure from superiors, respondents also faced ethical issues that concerned one's personal ethics. The use of confidential information for personal financial gains or insider trading was ranked fifth amongst other issues. Again, the legal implication of the problem has to be taken into serious consideration.

## **C) Offering and accepting of advantages**

Offering of advantages, excessive gifts and even bribes by customers or suppliers was another type of pressure and temptation faced by non-practising professional accountants. In general, respondents considered that the Professional Ethics Statements issued by the HKSA and the code of conduct of their own organisations were useful means in assisting them to handle these ethical issues.

## **2) Practising Sector**

Practising professional accountants can be sole practitioners in business on their own, in a partnership or salaried employees of professional accounting firms. Yet irrespective of their different roles, ethics comes into play in their workplace.

## Summary of the Survey Findings

### **A) Relationship with clients and obtaining professional work**

This is the area where respondents identified the top five most common ethical concerns. Fee problems ranked first. Opinion shopping by clients and unethical solicitation of professional work were ranked fifth and sixth respectively. This revealed that professional accountants in the practising sector were concerned with the need to maintain professional and work ethics amidst keen competition in the industry.

Pressure from clients posed another ethical issue. Financial information manipulation by clients and clients' proposals for tax evasion were ranked third and fourth respectively.

### **B) Conflicts of interest**

A considerable number of respondents indicated that close personal relationships with clients, e.g. mutual business interests, close friendship and financial involvement with clients would lead to conflicts of interest and could affect objectivity and independence in discharging their duties. Respondents pointed out that to strike a balance between building a good relationship with clients and maintaining due independence in work was not an easy task.

### **C) Soliciting, accepting & offering advantages**

Ranking of ethical issues under this area was much lower than that of "close personal relationship with clients". Probably most professional accountants would not encounter situations of the direct offering or acceptance of advantages from the outset. In general, respondents considered that Professional Ethics Statements issued by the HKSA and the code of conduct of their own organisations were useful means in assisting them to handle ethical

issues. However, professional accountants should be aware of temptations in which some clients might abuse the "grey areas", such as conflicts of interest to put professional accountants in a difficult and delicate position.

#### **D) Use of confidential information**

Use of clients' confidential information for personal gain was quoted as another common ethical concern by the respondents. Practising professional accountants will come across confidential information in their course of work. It is important that while performing professional work, they should neither use nor appear to use that information for his personal benefit or for the benefit of a third party.

# Chapter 3

## ETHICAL DECISION MAKING

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*"Our members who must deal with such a dilemma find first hand that compliance with ethical standards is a very personal matter involving their livelihood ..... Ethical decisions, rather than being made in the supportive environment described earlier, are having to be made in a difficult or even hostile environment. These decisions are made right down in the trenches - on the real ethics battlefield for some people". (Siers, 1991)*

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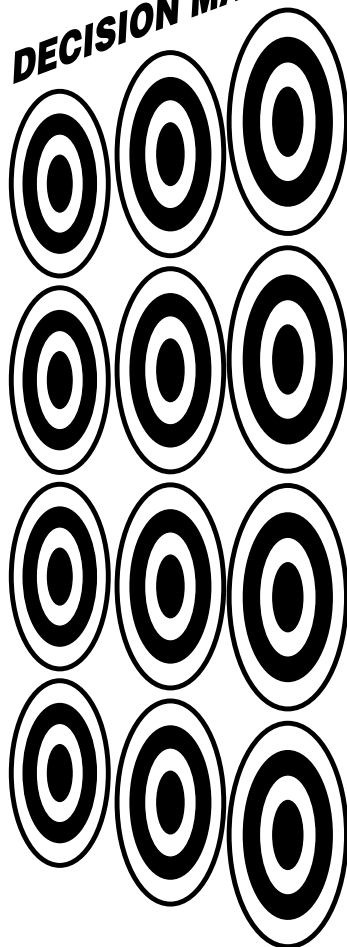
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**DECISION MAKING**



## ETHICS PLUS Decision Making Model

In the last chapter, we learnt that ethical issues are often encountered in the work of professional accountants. In fact, as the business environment continues to develop rapidly, the possibilities of facing ethical dilemmas invariably increase. This calls for an urgent need for professional accountants to develop the necessary skills for making sound judgements in handling ethical dilemmas in their work.

During the four corruption and fraud prevention seminars entitled "Achieve Excellence By Integrity : Corruption and Fraud Prevention Seminar for Accountants" co-organised by the HKEDC and the HKSA over the past two years, an **ETHICS PLUS** Decision Making Model developed by the ICAC was introduced to over 800 participating accountants and finance managers. Many participants considered the Model another helpful tool for tackling and resolving ethical issues. The decision making model is a mental framework or thinking process for handling ethical dilemmas and reaching a chosen course of action in a structured and systematic way.

The **ETHICS PLUS** Decision Making Model delineates the process and standards used for making ethical decisions:

### **ETHICS** process - Six Steps to Follow

- E** establish the relevant facts and identify the ethical issues involved.
- T**ake stock of all "stakeholders" or parties involved.
- H**ave an objective assessment of each stakeholder's position.
- I**dentify viable alternatives and their effects on the stakeholders.
- C**ompare and evaluate the likely consequences of each alternative with reference to the four **PLUS** factors below.
- S**elect the most appropriate course of action.

### **PLUS** standards - Four Key Factors to Consider

Compare and evaluate each alternative by considering the implications of each of the following factors:

- P**rofessional/Trade-related/Company code of conduct. i.e. any conflict?
- L**egal requirements. i.e. any breach of the law such as the **Prevention of Bribery Ordinance, the Theft Ordinance** etc? (Relevant provisions of the Prevention of Bribery Ordinance and the Theft Ordinance are set out in Appendix II.)
- U**ncompromisable self values, e.g. honesty, trustworthiness, fairness, etc.
- S**unshine test. i.e. whether the issue can be discussed openly and the decision can be disclosed without misgivings.

An illustration is used to demonstrate how one might use the **ETHICS PLUS** Model to resolve an ethical dilemma.

---

Jonathan newly joined DEF International, a big trading company in Hong Kong, as chief accountant. His subordinate, Tom, a professional accountant and the accounting manager of the company as well as the brother of his fiancée, Mary,

had access to cash held by the company and was responsible for preparing both the receivables and payables accounts. During the year, Tom experienced a major financial problem.

While reviewing the company's financial statements, much to Jonathan's surprise, he discovered that Tom had manipulated accounting records and had been involved in "teeming and lading" in which he delayed the recording of receipts from debtors and sped up the recording of payments to creditors. This was to conceal the fact that he had withdrawn a substantial amount of money from the company without approval. When Jonathan discussed this with Tom, he was asked to keep the secret as the disclosure would ruin Tom's career. When Mary knew of the case, she strongly urged Jonathan to help her brother and promised she would repay all the amounts owed to the company for Tom immediately.

Should Jonathan blow the whistle and disclose Tom's misconduct?

---

If you were Jonathan.....

**E**stablish the facts and identify the ethical issues in question :

Facts :

- Tom, my future brother-in-law, had fraudulently withdrawn a substantial amount of money from the company.
- Mary promised to repay all outstanding amounts immediately.
- Probably no one would know of Tom's unauthorised act.
- As chief accountant, my duty is to oversee the operation of the whole department and cultivate a good culture within the department.

↓ Ethical Issue : Whether I should keep the secret for Tom?

**T**ake stock of all stakeholders involved :

- ↓ ■ Self
- ↓ ■ Tom



- My company & other staff
- Mary
- Accounting profession

## **H**ave an assessment of each stakeholder's position :

### **Self**

- if I do not report, I compromise my professionalism of not being independent and objective.
- do not fulfil my responsibilities as a department head.
- being disloyal to the company as the company may suffer financial loss.
- jeopardize my relationship with Mary if I disclose Tom's act.

### **Tom**

- may face disciplinary action taken by the professional body.
- may even face prosecution.
- may ruin Tom's career prospects.
- may change for the better if I give Tom a chance.

### **My company & other staff**

- substantial financial loss to the company.
- reputation may be impaired for having dishonest staff.
- will affect our corporate culture if everyone only cares about their self interest.
- tolerance to Tom's act will be unfair to other honest staff.

### **Mary**

- will hurt her feelings.
- may react strongly and break our engagement.

### **Accounting profession**

- may taint the reputation of the profession as Tom has breached the professional code and even the law.
- may affect public confidence in the profession and its members.

**I identify alternatives and assess the effects on each stakeholder :**

- a) keep the secret and do nothing.
- b) keep the secret and help Tom to cover up his act by manipulating the accounting records.
- c) keep the secret and let Mary pay back the company as soon as possible.
- d) keep the secret, ask Tom to resign and review the accounting procedures to prevent similar incidents from happening again.
- e) refuse Tom's request and report to the management/regulatory bodies.
- f) resign from the company.
- g) .....

**C ompare and evaluate each alternative with reference to the four PLUS standards :**

**P** *professional code of conduct/company rules :*

- HKSA Professional Ethics Statement 1.203 states that being a member of the accountancy profession, he has to uphold integrity, objectivity and independence.
- HKSA Professional Ethics Statement 1.290C (para.2) states that "If a member acquires knowledge indicating that his employer or someone acting on behalf of his employer may have been guilty of some default or unlawful act, he should normally raise the matter with management internally at an appropriate level. ....Where this is not possible or fails to resolve the matter, a member may wish to consider making a report to a third party".
- Professional Ethics Statements and the "Code of Conduct for Employees of Accountancy Practices" issued by the HKSA state that no professional accountants' objectivity should be affected by personal relationships. Do I favour Tom because he is my future brother-in-law?

- Any company rule requiring me, as chief accountant, to maintain complete and accurate accounting records and to act on behalf of the company with good faith and fidelity?
- Any company rule advising me what I should do if I discover wrongdoings committed by other company staff?

**L** *egal requirements :*

- Tom may have breached the Theft Ordinance (false accounting).
- If I help him cover up the matter, will I commit an act of conspiracy under the common law?

**U** *ncompromisable self values :*

- I have to ask myself whether a particular alternative is commensurate with my personal values, such as loyalty to my company and to the profession, honesty, integrity, fairness, care for my family. Which values are important to me?

**S** *unshine test :*

- Can I disclose my decision to any parties, including the company, family, friends and colleagues without misgivings ?

**S** *elect the appropriate course of action :*

- After comparing and evaluating each alternative against the **PLUS** standards, select an appropriate course of action which can maximize the important values and the interests of all stakeholders.
- Make a commitment to the choice and implement it.

## Case Studies

Based on the major findings of the HKSA's survey of the common ethical issues faced by professional accountants, four hypothetical cases have been developed. Go through the cases and tackle them by applying the **ETHICS PLUS** Decision Making Model. A worksheet is in Appendix III. Certain HKSA members were invited to share their views by providing commentaries on how to handle these cases.

### Case One - Conflicts of Interest & Professional Integrity

Jimmy and Billy studied Finance & Accounting in university together and became very good friends. After graduation, Billy started his own trading business. His company, B&B, had been expanding very fast and achieving a huge annual turnover. Jimmy pursued his career in accountancy and worked hard to become a partner in a CPA firm. Naturally, Billy became one of the major accounts of Jimmy's firm, contributing 10% of its professional income.

This year, B&B was facing a very difficult position. Apart from losing a few major customers, a significant loss was discovered after Jimmy's firm completed the year-end audit for B&B.

Jimmy was invited to lunch by Billy. Over lunch Billy told Jimmy that he was negotiating a big order. If he could successfully apply for a line of credit with a bank to handle the order, B&B's position would turn around.

By then, even more services would be needed from Jimmy's firm. However, he was worried that if the bank was aware of B&B's loss position, it would not grant credit facilities. Billy then suggested that Jimmy use whatever device he could to improve the financial position of his company. Billy promised Jimmy that he would be duly rewarded after overcoming this hurdle. He would reward him with an expensive car to show his appreciation. If Jimmy refused his request, he had no choice but to appoint another CPA firm next year.

What would you do if you were Jimmy?

## Commentaries on Case One

Jimmy's immediate response should be to leave Billy in no doubt that, whilst B&B is an important and valued client of his firm, no mixture of financial inducement or veiled threat, however great, would cause him to compromise his independence and professional integrity in connection with either the company's forthcoming audited financial statements or, indeed, any other professional engagements carried out for B&B or any other clients.

Jimmy should clearly give very careful consideration as to how to proceed. Billy's tactics display motivations which undermine his integrity and, accordingly, Jimmy should heighten his professional scepticism in all his future dealings with Billy. Jimmy would also find it helpful to consult with a fellow partner at this stage in considering his alternative responses to this sensitive situation and in clarifying his own professional responsibilities in the circumstances, although remaining mindful at all times of the need to preserve client confidentiality. In the event that Jimmy has no appropriate internal resources within his own firm to facilitate this consultation he should consider consulting on a "no name basis" with the Hong Kong Society of Accountants.

Whilst emphasising that the use of any "device he could to improve the financial position" of B&B is inappropriate, Jimmy should nevertheless assure Billy that he and his firm will do everything they can to help the company achieve its legitimate business objectives provided Billy wants to work constructively with Jimmy and his firm to meet the challenges faced by B&B.

If Billy indicates that he does want to work with Jimmy, then Jimmy should seek to understand precisely why Billy was prepared to go to such lengths which would surely jeopardize their relationship. Presumably, Billy would explain that securing this big new order is of fundamental importance to B&B's future and that he believes the negotiations for this crucial order will not be successfully completed unless the bank grants essential credit facilities to the company. Billy implies that this, in turn, is dependent on the view given by the audited financial statements. Accordingly, it would seem that

Billy's concern is that unless the audited financial statements give a favourable impression of the company's financial position, the order cannot be won.

Jimmy should first seek to establish with Billy whether his concerns are well founded. They should consider questions such as :

- has the bank ever been approached on this matter and, if so, has it given any indication of the terms and conditions upon which it will make the necessary credit facilities available to B&B?
- how strong is B&B's balance sheet? Have the losses this year totally extinguished the company's net assets? Does the company have any fixed assets which could be offered as security for the new facilities? Would any related party be prepared to guarantee the credit facilities on behalf of the company?
- do the company's financial forecasts indicate that, on a go-forward basis, assuming the contract was won, the required credit facilities could be serviced and what cover is implied?
- are there any other sources of finance available to B&B?

Jimmy should point out to Billy that with a well prepared case the bank may well place greater reliance on B&B's forecast profitability and cash flows rather than on historical financial information; particularly if Billy's belief that the company's position "would turn around" was an accurate expectation. If financial forecasts were not available, Jimmy could suggest that his firm assist with, and, if necessary, provide comfort on, their preparation. Jimmy might further suggest that his firm could assist Billy in preparing a proposal to the bank incorporating the financial forecasts and other relevant information.

Jimmy should, however, be sceptical about Billy's claim about a dramatic reversal of the company's fortunes were the order to be won. It may simply reflect Billy's growing desperation following the loss of certain major customers during the year. It may even be that the credit facilities to which Billy refers are essential to enable the company to meet its existing obligations as they fall due and be symptomatic of much wider going concern issues facing B&B which may have implications for the auditors' report.

If, unfortunately, Billy indicates that his position is unchanged and that he will carry through his threats, Jimmy should point out that, having substantially completed the audit that they were engaged to perform, his firm would propose to proceed with issuing their report which would of necessity be qualified if the financial statements did not show a true and fair view.

Having fulfilled their statutory responsibility by reporting to the shareholders, Jimmy should explain that his firm would tender their resignation, and under the Companies Ordinance be obliged to deposit a notice in writing at the company's registered office containing a statement of circumstances connected with their resignation which they consider should be brought to the attention of members or creditors of the company. Details of these circumstances would also need to be given to any proposed successor firm of auditors in etiquette correspondence. In the event that B&B were to attempt to remove Jimmy's firm from office, Jimmy should explain that he would need to consider making similar representations to the shareholders as entitled under the Companies Ordinance.

In all circumstances, however, Billy's actions in the face of B&B's current difficulties have seriously questioned his integrity, Jimmy should retain a heightened degree of professional scepticism in all future dealings with Billy and B&B including reassessing the engagement risk associated with the decision to continuing serving this client.

## Case Two - Loyalty to Employer vs Responsibilities to Other Stakeholders

Patrick was employed as a financial controller of an expanding manufacturing enterprise which was planning to go public. In order to project a good financial performance, the Managing Director hinted that Patrick should handle the financial estimate and anticipated sales growth meticulously. He made it clear to Patrick that he would not bother which accounting method Patrick would use because Patrick was a professional.

In selecting a merchant bank to arrange for the listing, Patrick's recommendation was considered seriously by the board. Different bank managers approached Patrick to promote their services. Benny, who was the Marketing Director of the OPO Bank, called at Patrick's office. After introducing the bank's offer, Benny further mentioned that he was currently handling an acquisition plan. He could release some reliable information to Patrick if the latter helped him get the business.

Patrick didn't take Benny's words seriously. Based on the objective report he prepared, OPO Bank was engaged to proceed with the listing of the company. Finally, the company was listed successfully. The directors were enthusiastically considering some expansion plans which needed the support from banks. Once again, the Managing Director asked Patrick to be cooperative and help manipulate some management accounting data to facilitate the granting of credit facilities by banks. Patrick frowned at the Managing Director who then said, "Patrick, don't worry. It's just a normal business practice. We aren't doing anything wrong. We just plan better".

While Patrick was contemplating how to handle the Managing Director's request, the Assistant to the General Manager asked Patrick to issue a cheque of \$50,000 to a Mr. Wong, a bank manager in charge of the credit department. The Assistant said that it was approved by the General Manager and all Patrick needed to do was to sign the cheque and book it as "Entertainment" expenses. Patrick wondered whether this was another "normal business practice".



After the Assistant to the General Manager left, the phone rang. It was Benny. Benny invited Patrick to dinner saying that he would keep his promise of passing some "valuable information" to Patrick.

If you were Patrick, what would you do? How would you handle the requests of the Managing Director and that of the Assistant to the General Manager as well as the invitation of Benny to dinner?

## Commentaries on Case Two

### ***Financial Projection for Listing***

Surely Patrick should handle the financial estimates and anticipated sales growth meticulously. He should also document his bases of assumptions and agree those with the Managing Director. All these will be reviewed by the merchant bank (which sponsors the listing) as well as the reporting accountant, and the eventual delivery of the forecasts will be a matter of public and regulatory scrutiny once the company gets listed. Although the Managing Director was not bothered which accounting method Patrick would use, Patrick should ensure that applicable SSAPs issued by the HKSA are followed and that if there is no HKSA pronouncement, then the best accounting practice should be adopted.

### ***Managing Director's Request for Manipulation of Management Accounting Data***

Patrick should explain to the Managing Director that, first of all, a wilful act of manipulation of accounting data is a criminal offence. Secondly, accounting information presented to banks would most likely be audited. Once the banks realize that there are significant discrepancies between management accounting data presented previously and the audited accounting data, they would ask for explanations which would well call into question the credibility of the company, and in the worst case banks could withdraw financial support .

### ***Request for a Cheque by the Assistant to the General Manager***

Patrick should report the matter to the Managing Director and explain the legal consequences of being involved in such an act. Patrick should take the opportunity to urge the Managing Director to issue a set of codes of conduct to strengthen the system of internal control.

### ***Offering of 'Valuable Information'***

Firstly, the valuable information is likely to be inside information which, if used to deal in listed securities, could have severe legal consequences. Secondly, since Patrick's evaluation of merchant bank was done in an objective manner, there would be no reason why he should want to accept any 'gift' as a result of OPQ bank being appointed. This should be made clear to Benny. If Patrick's dinner with Benny is no more than a social entertainment, Patrick need not avoid it. If by accident Patrick has heard of the valuable information from Benny but he does not deal, counsel nor procure other persons to deal in the securities, he will not be in breach of the Securities (Insider Dealing) Ordinance.

## **Case Three - China Trade**

Andrew was the chief accountant of Hightech International which was a large trading company. Due to keen competition, the business of Hightech deteriorated substantially. To improve the situation, the company attempted to invest in the Mainland.

When reviewing the books and bank statements, Andrew found that there was evidence of fraudulent activities involving a senior sales representative. Andrew discovered that there were no supporting documents for some cash payments claimed by the sales representative. When asked for an explanation, the sales representative replied that those expenses had been incurred for the purpose of building up new business in the Mainland. He further explained that

the offering of commission to agents of business clients was a common practice. When consulting the Marketing Director who was a long serving staff of the company, he said, "Oh yes, they're approved by me. As far as I understand, the Accounting Department's responsibility is to settle the payments and process the reimbursement. We do have expense accounts for sales personnel. Am I right?"

With no choice, Andrew went to see the Vice-president. The Vice-president pacified Andrew and said, "In real business life, we have to tolerate some minor variations in order to get the job done".

Next day, a cheque was placed in front of Andrew and the phone rang. It was the Marketing Director. Andrew was asked to sign the cheque and was told that it would be deposited in a designated Hong Kong bank account belonging to a buyer of a firm in the Mainland. The arrangement enabled the buyer to pay for his various expenses while on business in Hong Kong. He further suggested that the sum could be paid by an overseas subsidiary of Hightech.

Although Andrew knew that the client was very important to Hightech, he suspected the payment might be unlawful.

What would you do if you were Andrew?

### Commentaries on Case Three

Andrew of Hightech International should :

1. Get all the facts. Don't guess and form an opinion yet. Innocent until proven guilty.

- 1.1 This payment is legal if

- the buyer is permitted by the Mainland company to accept it. Then Andrew must ask for a written authorisation.
- paid to an independent party who acts as a consultant to Hightech International to procure business. Then Andrew can demand an invoice.

1.2 This payment is not legal if

- the buyer is taking the money for his benefit without the knowledge of his employer.
- it is taken by the management of the Mainland company for their own benefit.

1.3 Andrew must find out if the Mainland company is trying to

- reduce its tax liability. If so, tax planning may achieve the objective.
- stash away foreign currency overseas so that it can save money in buying and selling foreign currencies.

1.4 Andrew must determine

- whether the amount is material enough or recurring enough to warrant an investigation.
- whether this is an ethical or legal question.

2. Andrew must ascertain the attitude of the management of Hightech International :

2.1 Is there a company policy on offering and acceptance of advantages?

2.2 Is he asked to do something against his own professional integrity, e.g. concealing the real purpose of the payments?

2.3 Is the management aware that what it is proposing to do is illegal?

3. Andrew should offer advice to the management of Hightech International if there are some better alternatives. He must take into account his own

views on ethics and legality. Some actions are both legal and ethical but some are legal but not ethical.

4. If after investigation, his worst fears of corruption are confirmed and Hightech management is fully behind it and all his attempts to find legal and ethical alternatives are rejected, then he must resign from Hightech International and refuse to carry out any illegal transactions.

## **Case Four - Whistle-Blowing**

ABC Company Limited was a publicly listed company. Howard, aged 35, joined the company as an internal auditor.

One day, he received an anonymous letter alleging a possible fraud in the company. Following Howard's diligent investigation, there was evidence showing some wrongdoings of Mr Szeto, the Purchasing Director and a close relative of the Managing Director. The malpractices included operating bogus companies to supply materials to ABC, accepting secret commissions in awarding contracts and claiming private expenses through the company's accounts.

He presented his findings to the Managing Director and expected praise and appreciation for his detective work. However, the response of the Managing Director was totally unexpected.

The Managing Director "accused" Howard of being over-zealous in the case. He said that Mr Szeto was a respected senior member of staff in the company. The evidence was also questioned in minute detail and the variations were described as minor. Finally, the Managing Director advised Howard to stay away from the case.

How should Howard react? What would you do if you were Howard?

## Commentaries on Case Four

It is evident that Howard has received an unsatisfactory answer from the Managing Director. Assuming his findings are accurate, he should present a report to the other directors of ABC Company Limited, setting out the details of his findings of the malpractice of the Purchasing Director.

If the action taken by the board is satisfactory, then Howard needs take no further action. However, if the board action is unsatisfactory, then Howard should consider reporting the matter to the appropriate authorities after seeking legal advice. While maintaining confidentiality of company matters is an important consideration, Howard has to weigh this consideration against the public interest in disclosing such matters to the appropriate authorities.

As there is no definition of public interest given by the courts, the HKSA's Professional Ethics Statement 1.290C suggests the following matters to be considered :

- 1) the relative size of the amounts involved and the extent of the likely financial damage;
- 2) whether members of the public are likely to be affected;
- 3) the possibility of likelihood of repetition;
- 4) the reasons for the employer's unwillingness to disclose the matters to the proper authority;
- 5) the gravity of the matter; and
- 6) any legal advice obtained.

# Chapter 4

## ETHICAL MANAGEMENT- CORRUPTION AND FRAUD PREVENTION

*"A politician may claim: 'This is a recession we had to have'. Professional spokesmen may claim: 'No form of accounting can eliminate fraud, greed, bad faith and deceit'. These are all excuses, invented by the powerful to gloss over their failure to cope with things they have been entrusted with and given the responsibility to management".<sup>8</sup> (Chambers, 1991)*

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While ethical decision making is important to individual professional accountants, the long term and fundamental solution to reduce opportunities for corruption, fraud and other unethical practices in an organisation is ethical management. The formulation of an effective company code of conduct, the setting up of a proper system of internal controls and the running of well-planned ethics training programmes are all integral parts of ethical management and contribute to the promotion of an ethical corporate culture. Professional accountants, as members of the management team, do play important roles in the ethical management of their business organisations.

## The Current Corruption and Fraud Scene

The number of corruption reports regarding the private sector has remained high in Hong Kong since the '80s. This trend continued and in 1996, over 53% of 3,108 corruption reports to the ICAC concerned the private sector. Furthermore, fraud surveys conducted by a Hong Kong CPA firm in recent years revealed that one-third of the responding companies had experienced fraud during the twelve months prior to the surveys. More than one third of the respondents who had experienced fraud detected losses of HK\$1 million or more.

## Red Flags from ICAC Cases

- In order to influence a bank to grant credit facilities, three directors of a group of companies asked their accountant to manipulate the financial statements by inflating the profits and understating the liabilities. In fact, their companies were making losses. The plot caused the bank to grant credit facilities totalling \$56.7 million. As a result, all three directors and the accountant were prosecuted and found guilty.

- A finance and administration manager and an accountant of a trading company abused their authority to deceive the company out of over \$10 million. Within two and a half years, they signed a total of 39 cheques payable to themselves or friends on their behalf or bogus companies under their control. Although each cheque was below their authorised limit, the total value of the 39 cheques exceeded \$10 million. To account for their dishonest cheque payments, the accountant and the manager conspired to make false entries in the company's accounting records. They falsely showed that the payments were for settlement of debts incurred by the company in its business transactions.
- For eight long years, corruption and fraud plagued a sizeable catering company. In order to maintain a steady flow of substantial and lucrative orders, a number of suppliers of the company bribed a corrupt syndicate within the company which included members from top management, supervisory ranks and frontline staff. The suppliers who paid were, in return, assured of preferential treatment and acceptance of sub-standard goods. Other fraudulent practices in the company included the operation of "shell" companies and acquisition of proprietary interests in companies trading with the catering company. The total sum of corrupt payments amounted to \$3.23 million.

The above figures and cases reflect various forms of corruption, fraud and malpractices which happened in business organisations. However, they could have been prevented if proper systems of internal controls were in place. As "financial stewards", professional accountants can make an important contribution in the prevention of corruption and fraud.

# Professional Accountants' Responsibilities for the Prevention of Corruption and Fraud

## 1) Non-Practising Sector

Occupying positions as financial controllers, accounting managers and internal auditors, non-practising professional accountants play a dual role in organisations as a professional and a manager. The following measures can be adopted for corruption and fraud prevention:

### A) Formulating a Company Code of Conduct to Build Up an Ethical Culture

Intended fraudsters or employees who made bad ethical decisions at work may claim what they did was an acceptable practice or would be condoned by the management. A company code of conduct can close these "defences". It is a written statement of the standard of behaviour expected by a company of its management and employees.

Basically, the code should include a detailed set of operating principles for management and staff to follow in dealings with customers, suppliers, contractors, public officials and other parties who have a relationship with the company. In parallel with the professional code of conduct of the HKSA, some core issues that a company should address include:

- offering or acceptance of advantages;
- conflicts of interest;
- use of confidential information;
- maintenance of true records;
- outside employment;
- company property; and
- channels of complaint.

## B) Establishing a System of Internal Controls to Prevent Unethical Behaviour

Professional accountants can contribute to the establishment of an effective system of internal controls, especially those controls that are related to functional areas prone to malpractices such as accounting and finance, purchasing and inventory control.

In the following tables, red flags and common malpractices with possible preventive measures for these functional areas are discussed :

### i) Accounting/Finance

#### Red Flags

- Poor security over cheques, cheque books and bank payment instructions.
- Weak control over documents between approval and processing.
- Management override of normal approval procedures.
- Last minute requests for payment not supported by relevant documentation.
- Unusual arrangements with banks for authorisation of transactions.
- No independent check on items going through suspense accounts.
- Large number of adjustments on particular accounts or on bank reconciliations.
- Numerous and repetitive items on exception reports.

#### Common Malpractices

- Accepting advantages for speeding up payments or delaying the collection of debts.
- Accepting advantages for granting credit facilities that are not supported by adequate security.
- Misuse of cheques.
- Claiming reimbursements for fictitious expenses.
- Misusing suspense accounts for fraudulent purposes.
- Teeming and lading.

### Preventive Measures

- Set up procedures for making payments and collecting debts.
- Date, cross-reference and regularly check all invoices, vouchers and receipt records to ensure they match payments.
- Constantly conduct independent and random checks on debtor records and bank statements to detect irregularities.
- Set clear credit policies.
- Set clear procedures for making claims for expenses.
- Enforce internal controls over revenue and payment cycles and take note of control weaknesses highlighted by auditors.
- Review suspense accounts to ensure that entries are cleared regularly and on a timely basis.

## ii) Purchasing

### Red Flags

- Unusual prices, abnormal terms or specifications.
- Tender bids very close to each other.
- Unusual location of suppliers e.g. remote supplier used for routine services.
- Large number of invoices for a particular supplier just under the approval limit.
- Numerous contra entries or other adjustments on purchase ledger.
- A small supplier for a wide range of products and services.
- Unfolded invoices (showing they have never been in the mail).
- Unusual delivery time or methods.
- Excessive purchases or stock surpluses.

### Common Malpractices

- Accepting advantages from bidders for disclosing selection criteria or other tender bids.
- Soliciting advantages as a reward for showing favour in placing orders, making excessive purchases, tolerating overcharging and accepting sub-standard goods and services.

- Setting up bogus firms to obtain purchase orders or contracts from their companies; then acquiring goods at cheaper prices and reselling them to the company at higher prices.
- Appointing suppliers and contractors wholly or partially owned by staff themselves or their close relatives.
- Acquiring goods for private use.

### Preventive Measures

- Draw up a list of approved suppliers and conduct random checks on additions and deletions.
- Set up a proper system for appointing suppliers or contractors.
- Specify conditions for urgent or special purchases to minimise their being used as a pretext to override normal procedures.
- Conduct random checks on quotations/tenders from successful and unsuccessful suppliers and compare prices.
- Be alert to the sudden disappearance of regular suppliers.
- Screen new suppliers by an appropriate tendering and credit check system.
- Check company registration records for details of owners and shareholders of suppliers to ensure they are not operated by staff.
- Segregation of duties.
- Keep receipts of goods and check whether there is any discrepancy from purchase orders.
- Record and investigate complaints from suppliers.
- Protect "sensitive information", e.g. by suitably classifying all information and setting up a monitoring system to ensure that users can be traced.

### iii) Inventory/Stock Control

#### Red Flags

- Unexplained differences between book and physical stock.
- Stock turnover in particular locations inconsistent with the general level of turnover.
- Delivery drivers asking for routes to be changed or to do the same routes.
- Deliveries made at unusual times of the day.
- Poor segregation of duties between buying, warehousing goods inward and accounting.
- Unexplained alterations to stock records or valuations.
- Unusual number of credit notes or adjustments near period ends.
- Frequent breakdowns of meters and weighbridges at unusual times.

#### Common Malpractices

- Taking advantages for covering up non-deliveries or short deliveries, or for accepting substandard goods.
- Overstating stock loss or damage to cover up pilferage.
- Stealing goods by fraudulently writing-off stock.

#### Preventive Measures

- Segregation of duties of purchasing and acceptance of goods upon delivery.
- Conduct random checks on damage claims.
- Keep proper records of all stocks.
- Proper approval procedures for stock write-offs.
- Keep a register of staff having access to warehouse keys.
- Routine rotation of delivery routes for drivers.
- Periodic physical stocktakes.
- Conduct regular checks on meters and weighbridges to avoid deliberate tampering.

## **C) Training Staff to Enhance their Ethical Standards**

Even though companies can develop comprehensive codes of conduct or establish elaborate system of internal controls, corruption and malpractices cannot be prevented if staff are always seeking opportunities for personal gain. Hence, staff training is essential for an effective, corruption and fraud-free organisation.

There can be different kind of training, ranging from enhancement of staff's knowledge of legal requirements, to polishing their skills in handling ethical dilemmas and preventing corruption and fraud. It is through formal training that staff are made aware of the values and principles embodied in the code of conduct, and at the same time are advised on how to handle work situations involving corruption, fraud and conflicts of interest.

## **D) Establishing Channels of Complaint**

A formal channel to receive complaints of alleged breaches of the code should be established and made known to employees as well as customers, suppliers and other parties concerned. Complaints, including those that are anonymous, should be followed up expeditiously by a senior member of staff holding an independent monitoring position, such as the chief internal auditor.

## **2) Practising Sector**

Like other organisations, professional accountants who are sole practitioners or senior partners of audit firms have the responsibility for ethical management within their firms. The above-mentioned corruption and fraud prevention measures, such as formulation of a code of conduct, establishment of a system of internal controls, enhancement of staff training and establishment of complaint channels are useful devices for building up an ethical culture within their firms.



As for employed practising professional accountants, while it is not the role of auditors to prevent corruption, fraud or other irregularities, their recurring annual audit work may act as a strong deterrent. The auditor has a responsibility to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements as stated in para. 10 and para. 12 of the HKSA Statement 3.271 "The auditor's responsibility in relation to fraud, other irregularities and errors".

## A) Warning Signs

The auditor seeks to obtain reasonable assurance that the financial statements do not contain a material misstatement. In Appendix 1 of Statement 3.271, warning signs are listed to assist auditors in assessing the risk of material misstatement. The key warning signs are as follows :

### Business Environment

- nature of the business, such as assets readily susceptible to misappropriation.
- circumstances which may unduly influence management such as the holding of shares or options by management.
- pressure to meet a profit forecast.
- unusual transactions with third parties and with companies registered in tax havens.
- liquidity under pressure and borrowing limits almost reached.

### Control Environment

- management override.
- incompetent personnel in control functions.
- lack of segregation of duties.

- weak internal control, such as weaknesses in procedures for reconciliation, safeguarding assets, authorisation, etc.
- doubts about the organisation's existence as a going concern.

### **Fraud Indicators**

- poor accounting records in general.
- evidence of falsified documents.
- figures, trends or results which do not accord with expectation.
- unusual items in reconciliations or suspense accounts.
- unusual investment of funds held in a fiduciary capacity.
- commissions or fees which appear either excessive or unusually low.
- large payments in cash or by bankers' draft via overseas "shell" companies or numbered bank accounts.
- payments made to officials of domestic or overseas governments.
- correspondence between the client and its regulatory authority concerning problems with authorisation.
- investigation by government departments, the police or the ICAC.

## **B) Tests in Detecting Fraud and Other Irregularities**

Many tests normally performed by auditors may assist in detecting fraud and other irregularities, for instance substantive tests performed on the debtors ledger for revealing overstatement of ledger balances or existence of bad debts, analytical review procedures for detecting unusual account balances and review of the minutes of board meetings for detecting possible existence of contingent liabilities.

## Disclosure of Defaults or Unlawful Acts by Professional Accountants

While professional accountants, whether in practice or not, should always keep a client's affairs in confidence (as stated in para. 3, Statement 1.204B) and has a general duty to his employer to act in good faith and fidelity, including a duty to keep confidential information obtained as a result of his employment (as stated in para. 4, Statement 1.290C), yet **"the duty of confidentiality is not absolute"**.

In Statement 1.204B "Professional Ethics - Unlawful Acts or Defaults by Clients of Members", Statement 1.290C "Professional Ethics - Unlawful Acts or Defaults by or on behalf of a Member's Employer" and Statement 3.271 "Auditing Guideline - The Auditor's Responsibility in Relation to Fraud, Other Irregularities and Errors", general principles and guidelines relating to disclosure of client's and employer's information are given.

In general, professional accountants should report suspected corruption, fraud and other irregularities to the management and the audit committee. If the matter is not satisfactorily resolved and depending on its gravity and seriousness, professional accountants should consider making a report to a third party in the public interest.

Professional accountants can normally disclose client's or employer's confidential information to a third party when :

- there is a **public interest** to disclose, e.g. where the employer has committed or proposes to commit a crime, fraud or misdeed;

- there is a **legal or professional right or duty** to disclose, e.g. under a court order or under particular laws such as the Prevention of Bribery Ordinance, the Inland Revenue Ordinance and the Drug Trafficking (Recovery of Proceeds) Ordinance etc.; and
- it is for the **protection of one's own interest**, e.g. to defend himself against a criminal charge, to resist a legal action against him and to defend himself against disciplinary proceedings.

It should be noted that :

- before making a decision to disclose client's or employer's confidential information, professional accountants should refer to the above HKSA Professional Ethics Statements for guidance and also consider seeking legal advice and / or consulting with the HKSA;
- whilst it is a concept recognised by the courts, no definition of "public interest" has ever been given by the courts; and
- the exception to the duty of confidentiality covers only disclosure to one who has a proper interest to receive the information.

# Chapter 5 SERVICES AND ASSISTANCE

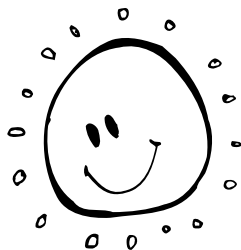
*"..... time has taught me that enforced adherence to rules is not professionalism. Moral and ethical principles are only effective when they are written on the heart." (Grice, 1993)*

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Professional Standards  
Department, HKSA

Hong Kong  
Ethics Development  
Centre



To enhance the standard of professional ethics, the Hong Kong Society of Accountants (HKSA) and the Hong Kong Ethics Development Centre (HKEDC) provide the following services and assistance :

## **Hong Kong Society of Accountants**

To promote and maintain a high standard of professional conduct and to give guidance to members, the Council of the HKSA (Council) issues statements on various aspects of professional ethics which are contained in Members' Handbook Volume I. The Ethics Committee is delegated to assist the Council in this area. The responsibilities of the Ethics Committee include:

### **1) Setting the standards**

The Ethics Committee is responsible for the development of new ethical guidance and updating existing ethical Statements and Guidelines contained in Volume I of the Members' Handbook.

### **2) Providing interpretations of Professional Ethics Statements and Guidelines**

In response to general enquiries, the Committee's Secretariat will deal with them in the first instance. This should provide a satisfactory response in most cases. In case the enquiry relates to an area or involves circumstances which the Secretariat considers appropriate to bring to the attention of the Committee, the Committee will consider the issue and give its views. Sometimes, these enquiries may trigger a review of the relevant Professional Ethics Statement.

### **3) Enforcing the ethical standards**

The best-set standards have to be enforced in order to be effective. Complaints of ethical misconduct by members and the public are duly handled by the Ethics Committee. When complaints are upheld but minor in nature, warnings may be issued to the member concerned. For serious matters, the Council will consider and decide the appropriate course of action, either a warning or referral to the Disciplinary Committee.

#### **4) Enhancing members' knowledge Of professional ethics**

The Committee is continually seeking ways to enhance members' and the public's knowledge and understanding of professional ethics. Members of the Ethics Committee have participated in Continuing Professional Education seminars, workshops such as those jointly held with the HKEDC, and other functions as speakers and group facilitators. Occasionally, "Ethics Questions & Answers" features are also published in the HKSA's bi-monthly journal "The Hong Kong Accountant".

#### **5) Handling enquiries**

For enquiries, please contact the Secretariat of the Ethics Committee, namely the Professional Standards Department of the Society in the first instance, at

**4/F., Tower Two, Lippo Centre,  
89 Queensway, Hong Kong.  
Tel. : 2287 7228 Fax. : 2865 6603  
E-mail: [hksa@hksa.org.hk](mailto:hksa@hksa.org.hk)**

### **Hong Kong Ethics Development Centre**

Established under the auspices of the Community Relations Department of the Independent Commission Against Corruption, the HKEDC aims to promote business and related ethics in Hong Kong on a long-term basis and to ensure a clean and effective business environment. It maintains close contacts with overseas ethics promotion organisations to keep abreast of the latest developments in business and professional ethics. It also provides a wide range of services to the business community in Hong Kong:

#### **1) Ethics Resource Centre**

A wide-ranging selection of reference materials has been collected, including



local and overseas books and journals relating to business and professional ethics and sample codes of conduct of a variety of trades and professions. Audio-visual training packages and materials are also available.

## **2) Consultancy service on corruption and fraud prevention**

A team of experienced officers offers a full range of consultancy services for companies and interested organisations in developing corporate ethics programmes, formulating/reviewing codes of conduct, setting up/improving systems of control and designing/conducting staff training programmes.

The Advisory Services Group in the ICAC Corruption Prevention Department offers free, confidential and expert advice on company's control systems and work procedures to prevent corruption and fraud.

## **3) Training seminars and workshops**

Tailor-made seminars and workshops on corruption and fraud prevention for different functional areas, such as sales and marketing, purchasing, personnel and administration etc., are organised. For particular professions, such as accountancy and engineering, the Centre joins relevant bodies to conduct seminars for their members.

## **4) Publications and training videos**

The Centre produces and distributes a variety of publications and training materials:

- *"Ethics in Practice" Newsletter - a regular publication featuring different issues related to business and professional ethics. Local and overseas academics and experts are invited to contribute articles to share their experience in promoting ethics;*
  
- *"Ethics Plus" Package - a comprehensive guide for corporate ethics programme;*

- *"Corruption and Fraud File" - a collection of corruption and fraud cases handled by the ICAC; and*
- *"A Legal Guide for Investors in Guangdong and Hong Kong" - a joint publication with the Guangdong Provincial People's Procuratorate in which anti-bribery legislation and ways to handle corruption problems in Hong Kong and in Guangdong are discussed.*

Training videos depicting ethical dilemmas in the workplace for senior managers and front-line staff of specific trades, e.g. real estate, banking are also produced.

## 5) Enquiries

You are welcome to make enquiries and use the services of the Centre at :

**1/F., Tung Wah Mansion,  
199 - 203 Hennessy Road, Wanchai, Hong Kong.  
Tel. : 2587 9812 Fax. : 2824 9766  
E-mail: [hkedc@hkstar.com](mailto:hkedc@hkstar.com)**

## 6) Other Services

ICAC provides convenient, responsive and confidential corruption reporting and enquiry services. Parties may contact any ICAC Regional Offices or its Report Centre's 24-hour hotline : 2526 6366.

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## References & Appendices

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# Appendices

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## Appendix I: HKSA's Survey Findings

### 1) Non-Practising Sector

#### ***Respondents' Profile***

*Out of the 1,254 respondents who returned the questionnaire, 705 (56%) belong to the non-practising sector. A majority of the non-practising respondents work as senior managers in big corporations (employing more than 500 employees) of the trading, banking and finance sectors. Over 50% of the non-practising respondents have post-qualification experience of less than 10 years.*

*In the questionnaire, 15 ethical problems were listed. Respondents were asked to indicate the more common ethical issues they might encounter (they might choose less than ten items). The results from the 705 non-practising respondents to the 15 ethical issues, ranked in descending order in terms of number of responses, are shown as follows:*

#### ***Ethical Issues & Ranking***

- 1.** Pressures from the superiors to project the desired financial performance to the outside world.
- 2.** Transfer pricing and overseas markets.
- 3.** Instructions to provide inflated management accounting data, e.g. monthly sales figures, for sales and marketing purposes.
- 4.** Pressures from the superiors to pass their private or illegitimate business expenses through the accounts of the organisation.
- 5.** Use of confidential information for personal financial gains/insider dealings.
- 6.** Under-declaration of taxable profits/underpayment of taxes.

7. Dealings with customers with dubious reputations, e.g. a history of bad credit but closely related to senior management.
8. Advantages, excessive gifts or bribes by customers or suppliers.
9. Instructions to prepare certain internal documents for non-commercial reasons, e.g. in support of an application for working visas for the overseas relatives or business associates of your superiors to work in Hong Kong.
10. Concerning an organisation's malpractice and whistle-blowing.
11. Pressure to offer advantages as facilitating payments.
12. Instructions to perform functions considered unethical or illegal, e.g. to pay dividends payable to an overseas joint venture company into the personal accounts of the officials of the joint venture company in Hong Kong.
13. A non-executive directorship which may give rise to a conflict of interest.
14. Dealings with suppliers with dubious reputations, e.g. a history of violating the 'Country of Origin' Rules.
15. A huge pay rise by the employer in reward for turning a blind eye to certain irregularities or unethical acts.

## 2) Practising Sector

### ***Respondents' Profile***

*Out of the 1,254 respondents who returned the questionnaire, 549 (44%) belong to the practising sector. Almost all of the practising respondents are working in CPA firms. Over 50% are partners or directors in their organisations. A majority have post-qualification experience of less than 10 years.*

*In the questionnaire, 15 ethical problems were listed. Respondents were asked to indicate the more common ethical issues they might encounter (they might choose less than ten items). The results from the 549 practising members to the 15 ethical issues, ranked in descending order in terms of number of responses, are shown as follows:*

### ***Ethical Issues & Ranking***

1. Fee problems (billing, collection, contingent fee problems or competitive bids).
2. Personal relationships with clients.
3. Financial information manipulation by clients including change of accounting policies to enable reporting better results or financial position.
4. Clients' proposals for tax evasion or tax fraud.
5. Opinion shopping by clients.
6. Unethical solicitation of professional work.
7. Use of clients' confidential information for personal financial gain.
8. Accepting advantages.
9. Financial involvement with or in the affairs of clients.
10. Unreasonable requests from your superiors.
11. Soliciting advantages.
12. Offices and employments in other businesses.
13. Offering advantages.
14. Loans to/from clients.
15. Bribes.



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## Appendix II: Extracts of the Prevention of Bribery Ordinance and the Theft Ordinance

### A) Extract of the Prevention of Bribery Ordinance

#### Section 9

##### 'Corrupt transactions with agents'

(1) Any agent who, without lawful authority or reasonable excuse, solicits or accepts any advantage as an inducement to or reward for or otherwise on account of his -

- (a) doing or forbearing to do, or having done or forborne to do, any act in relation to his principal's affairs or business; or
- (b) showing or forbearing to show, or having shown or forborne to show, favour or disfavour to any person in relation to his principal's affairs or business,

shall be guilty of an offence.

(2) Any person who, without lawful authority or reasonable excuse, offers any advantage to any agent as an inducement to or reward for or otherwise on account of the agent's -

- (a) doing or forbearing to do, or having done or forborne to do, any act in relation to his principal's affairs or business; or
- (b) showing or forbearing to show, or having shown or forborne to show, favour or disfavour to any person in relation to his principal's affairs or business,

shall be guilty of an offence.

**(3)** Any agent who, with intent to deceive his principal, uses any receipt, account or other document -

- (a) in respect of which the principal is interested; and
- (b) which contains any statement which is false or erroneous or defective in any material particular; and
- (c) which to his knowledge is intended to mislead the principal,

shall be guilty of an offence.

**(4)** If an agent solicits or accepts an advantage with the permission of his principal, being permission which complies with subsection (5), neither he nor the person who offered the advantage shall be guilty of an offence under subsection (1) or (2).

**(5)** For the purposes of subsection (4) permission shall -

- (a) be given before the advantage is offered, solicited or accepted; or
- (b) in any case where an advantage has been offered or accepted without prior permission, be applied for and given as soon as reasonably possible after such offer or acceptance,

and for such permission to be effective for the purposes of subsection (4), the principal shall, before giving such permission, have regard to the circumstances in which it is sought.

## **Section 2**

**'Advantage' means :**

- (a) any gift, loan, fee, reward or commission consisting of money or of

- any valuable security or of other property or interest in property of any description;
- (b) any office, employment or contract;
  - (c) any payment, release, discharge or liquidation of any loan, obligation or other liability, whether in whole or in part;
  - (d) any other service, or favour (other than entertainment), including protection from any penalty or disability incurred or apprehended or from any action or proceedings of a disciplinary, civil or criminal nature, whether or not already instituted;
  - (e) the exercise or forbearance from the exercise of any right or any power or duty; and
  - (f) any offer, undertaking or promise, whether conditional or unconditional, of any advantage within the meaning of any of the preceding paragraphs (a), (b), (c), (d) and (e),

but does not mean any donation within the meaning of Part V of the Corrupt and Illegal Practices Ordinance (Cap. 288) particulars of which are contained in any return of donations submitted or corrected by a candidate under section 29(2A) or (7A) respectively of that Ordinance.

**'Entertainment' means :**

The provision of food or drink, for consumption on the occasion when it is provided, and of any other entertainment connected with, or provided at the same time as, such provisions.

## **B) Extract of the Theft Ordinance**

### **Section 18**

**'Obtaining pecuniary advantage by deception'**

(1) Any person who by any deception (whether or not such deception was the

sole or main inducement) dishonestly obtains for himself or another any pecuniary advantage shall be guilty of an offence and shall be liable on conviction upon indictment to imprisonment for 10 years.

(2) The cases in which a pecuniary advantage within the meaning of this Section is to be regarded as obtained for a person are cases where -

- (a) he is granted by a bank or deposit-taking company, or any subsidiary thereof the principal business of which is the provision of credit -
  - (i) a credit facility or credit arrangement;
  - (ii) an improvement to, or extension of, the terms of a credit facility or credit arrangement; or
  - (iii) a credit to, or a set off against, an account,

whether any such credit facility, credit arrangement or account -

- (A) is in his name or the name of another person; or
- (B) is legally enforceable or not;

- (b) he is allowed to borrow by way of overdraft, or to take out any policy of insurance or annuity contract, or obtains an improvement on the terms on which he is allowed to do so, whether any such overdraft, policy of insurance or annuity contract -
  - (i) is in his name or the name of another person; or
  - (ii) is legally enforceable or not; or

- (c) he is given the opportunity to earn remuneration or greater remuneration in office or employment, or to win money by betting.

## Section 19

### 'False accounting'

(1) Where a person dishonestly, with a view to gain for himself or another or with intent to cause loss to another -

- (a) destroys, defaces, conceals or falsifies any account or any record or document made or required for any accounting purpose; or
- (b) in furnishing information for any purpose produces or makes use of any account, or any such record or document as aforesaid, which to his knowledge is or may be misleading, false or deceptive in a material particular,

he shall be guilty of an offence and shall be liable on conviction upon indictment to imprisonment for 10 years.

(2) For the purposes of this section a person who makes or concurs in making in an account, record or document an entry which is or may be misleading, false or deceptive in a material particular, or who omits or concurs in omitting a material particular from an account, record or document, is to be treated as falsifying the account, record or document.

(3) For the purposes of this section, "record" (紀錄) includes a record kept by means of a computer.

## Section 21

### 'False statements by company directors, etc.'

(1) Where an officer of a body corporate or unincorporated association (or person purporting to act as such) with intent to deceive members or creditors of the body corporate or association about its affairs, publishes or concurs in publishing a written statement or account which to his knowledge is or may be misleading, false or deceptive in a material particular, he shall be guilty of an offence and shall be liable on conviction upon indictment to imprisonment for 10 years.

## Appendix III: Worksheet for Analysing the Cases by ETHICS PLUS Model

<p>1. Establish the facts</p>  <p>Identify the ethical issue(s)</p>	<ul style="list-style-type: none"> <li>■ _____</li> <li>■ _____</li> <li>■ _____</li> <li>■ _____</li> <li>■ I have to decide whether to _____ _____</li> </ul>
<p>2. List stakeholders &amp; assess positions</p>	<ul style="list-style-type: none"> <li>■ Self _____ _____</li> <li>■ Company _____ _____</li> <li>■ Accounting Profession _____ _____</li> <li>■ Others _____</li> </ul>
<p>3. Identify alternatives</p>	<p>(a) _____</p> <p>(b) _____</p> <p>(c) _____</p>

<p>4. Compare and evaluate each alternative against the key factors</p>	<p><i>Alternative (a)</i></p> <p>Professional Code/Company Rule _____</p> <p>_____</p> <p>Legal _____</p> <p>Self Values _____</p> <p>Sunshine Test _____</p> <p><i>Alternative (b)</i></p> <p>Professional Code/Company Rule _____</p> <p>_____</p> <p>Legal _____</p> <p>Self Values _____</p> <p>Sunshine Test _____</p> <p><i>Alternative (c) .....</i></p>
<p>5. Select the course of action</p>	<p>My decision is : _____</p>

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