

## ***THE AUDITOR ' S RESPONSABILITIES REGARDING BUSINESS ETHICS IN CONDUCTING A FINANCIAL AUDIT***

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*Abstract: This paper researches a different approach concerning the financial audit, ethical audit and business ethics that are different than the quantitative, easily measurable data that ensures reliability and accuracy in areas like accounting systems, financial reporting and legal compliance. In this context, the financial auditor deals with all kind of questions regarding ethics that he/she answer using a qualitative or subjective analysis.*

*Regarding the methodology employed in this research one of the most important is the professional judgment of the auditor regarding the company's commitment to ethics; in order to build such a judgment, the main technique used is the analysis of International Standards of Audit (ISAs), to be more precise of ISAs such as 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", 250 "Consideration of Laws and Regulations in an Audit of Financial Statements" and 260 "Communication with Those Charged with Governance".*

*The result of this research is a methodology made of a techniques and procedures used in the ethical audit that brought together form a guideline for the financial auditor in detecting the ethical issues that the accounting professional must solve in order elaborate the audit report that contains the audit opinion.*

*Keywords: audit, financial, ethics, standards, methodology.*

### **1. Introduction of ethical audit and its purposes**

One new key segment of the financial audit and especially nowadays is represented by the ethical audit that has as main objective to assess the internal and external entity' values base. The ethical audit is divided into two parts, an internal segment that has as objectives the review of people, processes and paper. The result of the internal ethical audit activity presented to the stakeholders groups in order to ensure that the values of the entity are accepted by its key stakeholders. Therefore, the findings of the ethical audit reflect significant management information that should be presented public, in the entity' reports, in order to present the social and ethical entity' performance.

The examination of entity' ethics derives of the following causes:

- Costly legal actions resulted of ethical audit failure that translate in high exists of cash flow and benefits for the entity;
- An ethical start up point, that has to be improved for ethical improvements;
- Stakeholders obligations that are represented by the users of financial statements and their need of ethical information regarding the entity due to the fact that financial audit reports present few information regarding ethical problems;

- Social pressure that derives as an external factor and influences the public image and opinion regarding the entity' activity;
- Management risk, a key factor that is significantly considered by the financial audit and many times has as result accounting fraud scandals that must be avoided;
- The desire to bring benefits both financial and non-financial just by having a proper ethical behavior from the point of view of the entity.

The ethical audit is a new term, process although business ethics represents an old and widely discussed topic. In Europe it is applied usually by an ethical code for each entity although in the United States in the recent period many entities have a management department with primary objective the promotion of ethical behavior through the entity.

As the financial audit presents an opinion regarding the fairness (or not) of the financial statements in order for the financial users to decide their future actions concerning that entity, the ethical audit has as main objective to present the ethical profile of the entity, the entity' reputation that affects not only the employees or investors but also the customers and suppliers. It performs in the following areas:

- learn and apply better issues that motivate the personnel due to other factors existence, not only the financial factors;
- identify and solve special areas that are vulnerable for the entity and could cause financial and non-financial issues;
- assess a certain start-up point in order to allow future progress;
- improve the stakeholder's opinion regarding the entity and provide guiding lines for expectation of entity's ethical behavior;

In conclusion, the ethical audit determines a certain climate that the entity evaluates in and analyses the values on which entity's actions are based by testing the values that should be taken into consideration with the moral actions that the entity applies. It represents a different concept not like social auditing which has as main objective the social impact of the entity on its environment.

## **2. Stakeholders and their influence on the entity subject of ethical audit**

One of the most important and being able to deteriorate or improve the entity' activity is represented by the customer, which translates into the influence, the power the consumer has on the entity. The mechanism and methods of the consumer (or possible consumer) to determine an entity to change its actions regarding a certain topic is increasing and widely spread. For example, on the social networks, some persons were encouraging others of boycotting the sales of a petrol producer and reseller in Romania due to that entity' proven financial fraud and prejudice brought to the tax authorities and the Romanian economy.

It is obvious that the financial audit is the main method to combat financial frauds but we must take into consideration also the ethical audit. If that petrol producer and reseller would have taken into consideration, not only the effects of fraudulent reports and financial fraud, but also the public negative effect their actions would have that situation could have been avoided; one of the greatest benefits of ethical audits are to analyze the ethical environment of the entity and to identify the these pressure groups that have the ability to influence an entity's activity, even to bankruptcy.

The ethical audit prevents negative events from happening and pressure groups of being unsatisfied. This is the reason that this kind of audit has to be taken into consideration by any entity that has claims, financial and non-financial.

One of the greatest benefits of the ethical audit is that it assists the company to scan the environment to identify the issues which are most likely to provoke action by pressure groups, and in turn gives the company the opportunity to encourage such groups to participate in the decision making process, or at the very least to inform them fully of the company's position.

What must be highlighted is that the entity should have in consideration the network of relationships, relationships with personnel, shareholders, especially customers and society at large. These stakeholders can influence the entity's activity; let us take the previous example with the petrol company, like any other entity, it should have considered important the customer, its key stakeholder, it should have asked the customer's opinion on services and allow the customer to play an active and positive role in its development; most important it shouldn't have committed financial fraud which is a very delicate topic in countries like Romania, especially in a recession period.

Ethical auditing determines entities to achieve a better relationship with its stakeholders; such a relationship has at the base values as trust and fair dealing, an entity advantage to others is finding the expectations and perceptions that offer a stronger and more reliable relationship than other entities do.

The dynamics of ethical audit involve the accountability and transparency towards stakeholders and effective internal control related to ethical objectives; these two key factors are influenced and fulfilled by:

- a. The stakeholders obtain the information needed and entitled to due to the existence of a minimum set of current legal standards and the importance of certain stakeholders that the entity wishes to emphasize and recognize;
- b. The stakeholders assess also the progress through years and determine if there is still work to be done regarding audit objectives

So, the ethical audit will result in the identification of (actual) organizational values on the one hand, and in a general direction as to how the company wants to develop its value system on the other. The findings will therefore need to be translated into action planning for the following year. If the ethical audit is performed every year or every other year, a company should be able to track its progress based upon the baseline information provided by the different elements of the ethical audit. Hence, the ethical audit provides a snapshot of the ethical behavior of a company, but at the same time ethical bookkeeping, ethical accounting, internal and external ethical assessment, external validation and the resulting action planning can influence organizational values and thus corporate ethical behavior.

### **3. General ethical standards and audit procedures**

Accounting and financial professionals must abide by ethical standards that regulate what kind of business they conduct, who they serve and how they use their skills. Ethical standards are determined largely by professional accounting and finance organizations and the Financial Accounting Standards Board.

In order to be able to conduct an ethical audit, the auditor himself / herself, especially a financial auditor, should apply the following professional principles:

- a. **Competence:** one of the key ethical standards finance professionals must uphold is to be competent, accountants and financial professionals must not only have secured education and practice that prepares them for their positions, but they must also continue that education by learning new information that can affect their practices. Among other things, they must stay up-to-date with national and international standards and regulations; also financial professionals must be honest and display integrity;
- b. **Objectivity:** financial professionals must be objective, avoiding conflicts of interest; they must not, for instance, perform accounting services or ethical audits for firms that they have a vested interest in. Even if they can conduct themselves objectively, working for a company owned by a relative, for example, would not look objective and could cast doubt on the finance professional's intentions;
- c. **Confidentiality:** financial professionals have access to a great deal of personal information, this is not only limited to financial information but also includes the names and contact information of employees as well as the names and locations of firms with which the company does business. Ethical standards require financial professionals to keep that information private except when ordered to disclose it by a court of law; financial professionals also must not use this information to gain “unethical or illegal advantage”.

Regarding **audit procedures for ethical behavior** the most effective tool that entities have for accomplishing a profitable relationship between an entity and its customers is the ethics audit. Ethics audit is influenced by the following audit procedures:

- a. **Audit independence:** Ethical behavior audit teams must be free from interference or impairment from any department or management function. Conflicts of interest are avoided by ensuring individual auditors are not assigned to evaluate the department the auditor reports to;
- b. **Written code:** ensure that the organization being audited has established a written code of conduct; the audit will evaluate whether or not the code addresses all of the business practices of the entity and the standards of behavior employees are expected to follow;
- c. **Leadership commitment:** an ethics audit also determines if the organization's leadership has made a commitment to enforcing ethical behavior from the top of the company down to the lowest levels of the organization; the audit determines if leadership has accepted responsibility for the creation of a culture that insists on ethical behavior from every employee; leadership's commitment to ethics can be quantified by surveys from customers and other stakeholders; an ethical company culture creates value when customers perceive they will be treated with dignity and integrity.

Ethical behavior on the part of the entity and its personnel translate into honest and valued relationships with both customers and business partners. Maintaining an ethical environment by applying ethical standards involves setting expectations, providing guidance along the way and consistently choosing to do the right thing.

An ethical environment can be achieved by applying the following **methods**:

- a. **Developing an ethical standards guide** that both entity management and employees to act in an honest and trustworthy manner in all interactions; these standards should encourage employees to make the right decisions for the company, not the individual, and give them the courage to come forward should they notice dishonest and unethical behavior. Company programs focused on ethics help lay out company standards and expected practices as they relate to ethical behavior and decisions. This can include providing clear guidance on common ethical dilemmas, such as using company software programs for personal projects.
- b. **Establishing core values** and working to develop a culture of respect, trust and honest communication represents a vital part of establishing and maintaining ethical business operations; entities should choose to reward employees for consistently meeting ethical standards set in place, instead of emphasizing financial gain.
- c. **Developing ethical managerial standards.** The actions and behaviors of management, and other senior staff, help steer departments and employees toward proper and accepted business practices. Part of this responsibility includes enforcing rules, guidelines and policies fairly and equally across all levels of the organization. Managers may also be tasked with helping employees navigate ethical dilemmas and solving difficult situations to keep the corporation on the right path.
- d. **Ethical personnel policy.** Addressing ethical standards for an entity starts with the hiring process; recruiting talented and ethical individuals is a must. Background checks represent just one tool available for recruiters when looking to hire ethical and trustworthy individuals. In addition to hiring the right employees, employers must take action to penalize those who display dishonest and unethical behavior. Continuing to employ those employees who cannot behave in an ethical manner sends the wrong message to all employees.

#### **4. Conclusions and proposals regarding the conduct of an ethical audit**

Financial audits are especially designed to verify the entity's records in order to ensure reliability and accuracy in areas like accounting systems, financial reporting and legal compliance. Audits generally deal with quantitative, easily measurable data. Ethical issues, on the other hand, are more often qualitative or subjective in nature. A number of qualitative research techniques make an ethical audit possible, but an ethical audit still necessarily functions differently from any kind of financial audit.

An ethical audit must be conducted in starting from the entity's formal codes of ethics, continuing with the past ethics events in the entity's history and ending questioning both employees and personnel and finalizing with an audit opinion. This **4 step method** is described below:

1. *Review the company's formal codes of ethics, ethics training programs and compliance policies for legal and industry guidelines regarding ethics.*

A commitment to ethics begins with formal policies in the employee handbook. Although having such policies in place does not guarantee real-world compliance, it is a vital first step in building a culture of strong ethics, and it can show how serious management is about ethical issues. The auditor should ensure that ethics policies cover the full range of common issues in business, such as: *discrimination, equal employment opportunity, financial*

*management, sourcing, customer relations and the impact of company operations on the environment, the community and the world;*

2. *Past breaches of ethics through company records and archived online news sources.*

The auditor should continue by asking the shareholders or an executive to discuss any legal issues the company has experienced, but should not let the impression that the auditor intends to investigate. If the auditor discovers something the entity's representative tried to hide, this represents an alarm signal pointing to a culture of dishonesty.

When searching past news releases, the auditor should look for any negative press about the entity, and scrutinize the story for breaches of ethics. If any previous ethical lapses have occurred, the auditor should speak with the entity shareholder/s or an executive about what the company has done to prevent similar incidents from occurring since then and in the future. To make this information more measurable, the auditor should create a timeline listing each past incident of a public breach of ethics, and analyze the frequency, rate and momentum of the occurrences.

3. *Employees questioning regarding their impressions of the company's commitment to ethics.*

The auditor should the employees to share their experiences about co-workers, managers and executives and assure that all employees know their interviews are confidential and that honest answers will help to improve their organizations. Insiders know a large amount of information that the public, the press and government regulators are not aware of. Not every breach of ethics is illegal, either, and employees can be an insightful source of information on legal breaches of ethics occurring on a regular basis. To make this information more quantitative, the auditor should look for patterns in the responses received and record the number of times specific issues come up. *If the auditor discovers employees frequently speaking about management's rude treatment of females, for example, the auditor should note the number of times the issue came up and calculate the percentage of interviewees who mentioned it.*

4. *The ethical audit opinion;* the ethical audit will result in the identification of entity's values on the one hand, and in a general direction as to how the company wants to develop its value system on the other. The findings will therefore need to be translated into action planning for the following year. If the ethical audit is performed every year or every other year, an entity should be able to track its progress based upon the baseline information provided by the different elements of the ethical audit.

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