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The Japanese Institute of Certified Public Accountants

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Ethical Leadership In A Digital Era: Applying The IESBA Code To Selected Technology-Related Scenarios

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Preface

Technology is transforming the way that professional accountants conduct their work processes and the content of the services they provide. Against this uncertain and dynamic backdrop, ethical decision-making has become more important than ever.

This paper is a non-authoritative publication with seven hypothetical scenarios developed to assist professional accountants in business and in public practice navigate practical issues in ethical leadership when using or implementing technology. Each scenario illustrates ethics, including independence, considerations for professional accountants as they apply the International Code of Ethics for Professional Accountants (including International Independence Standards) (the Code) in their decision-making.

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Introduction

This paper should be read in conjunction with the following four thought leadership pieces developed by Chartered Professional Accountants of Canada (CPA Canada), which build on a collaborative exploratory paper and global roundtable event held jointly with the Institute of Chartered Accountants of Scotland (ICAS) and the International Federation of Accountants (IFAC), entitled Ethical Leadership in an Era of Complexity and Digital Change.

- **Paper 1**, *Complexity and the professional accountant: Practical guidance for ethical decision-making*
- **Paper 2**, *Technology is a double-edged sword*
- **Paper 3**, *Managing bias and mis/disinformation*
- **Paper 4**, Mindset and enabling skills of professional accountants

Building on these papers, the scenarios in this paper describe applied practical situations involving technology-related tools, systems, and/or data, where professional accountants might face difficulty in acting in the public interest, in compliance with the Code. It includes seven scenarios, five relating more to professional accountants in public practice and two oriented to professional accountants in business, although the concepts being considered frequently overlap.

Scenario A: Forecasting impairment

Sanko Foods is a listed company that produces and sells food products. Four years ago, Sanko Foods acquired Sanko West Japan in order to expand sales in western Japan, a region it had not previously been able to penetrate. Goodwill was recorded at the time of the acquisition. However, the performance of Sanko West Japan after the acquisition has been poorer than initially expected. Since the acquisition, sales of Sanko West Japan have declined by approximately 10% each year. Given the historical sales trend, Sanko Foods conducted an impairment test to decide whether the company needed to record an impairment loss on related goodwill in the current year's group financial statements.

To generate more precise sales forecasts for the impairment test, Sanko Foods introduced an AI-based forecasting system developed by Sanko Data, a research company affiliated with Sanko Foods. Sanko Foods obtained sales forecasts for Sanko West Japan for the next three years from Sanko Data, which predict that sales will significantly improve across this period. Based on the sales forecasts, Sanko Foods concluded that the goodwill related to Sanko West Japan is not impaired and no impairment loss needs to be recorded.

In arriving at the conclusion, Ms. Ito, a professional accountant and the CFO of Sanko Foods, requested Sanko Data to provide the basis for its sales forecasts. Sanko Data explained that, for the inputs, it used the sales price and sales volume of Sanko Foods' products in the past; population trends in each region; sales prices and sales volume of similar products in competitive, comparable markets; predicted weather conditions and economic indicators, such as anticipated interest rates and stock prices. It then used an algorithm to estimate the expected sales volume and sales forecast for Sanko West Japan.

No supporting materials were provided by Sanko Data to explain: the specifications of the algorithm and data inputs; the extent to which it had been subject to testing prior to its introduction and the related testing results; and the nature and effectiveness of any controls over its application. Ms. Ito was not sure if she should request further information on the algorithm because she trusted Sanko Data's ability to develop AI-based forecasting tools and because Sanko Foods does not have personnel who can competently judge the suitability of the AI system in any case.

Yamato Audit Corporation, a mid-sized Tokyo-based firm, is auditing Sanko Foods' group financial statements. The audit engagement partner, Mr. Tanaka, is discussing with Ms. Ito the company's decision not to record an impairment loss for goodwill related to Sanko West Japan, including the appropriateness of the sales forecasts generated by Sanko Data's AI-based forecasting system. Both Mr. Tanaka and the firm, however, lack sufficient AI knowledge to assess Sanko Data's system. Mr. Tanaka is about to instruct the audit engagement team members to perform audit procedures to verify the overall valuation of goodwill.

Threats to Compliance with the Fundamental Principles

Integrity, Objectivity, and Professional Competence and Due Care

As a professional accountant, the Code requires Ms. Ito to comply with the fundamental principles. This includes being straightforward and honest in all professional and business relationships (R111.1); exercising professional or business judgment without being compromised by bias, conflict of interest, or undue influence of, or undue reliance on, individuals, organizations, technology or other factors (R112.1); and attaining and maintaining professional knowledge and skill at the level required to ensure that an employing organization receives competent professional service, based on current technical and professional standards and relevant legislation as well as acting diligently and in accordance with applicable technical and professional standards (R113.1).

The use of, or reliance on, the outputs of transformative technology, such as AI, might create threats to compliance with the fundamental principles. Relevant considerations for Ms. Ito in identifying such threats include, for example, whether the AI-based system is appropriate for the purpose it is being used for and whether she has the professional competence to understand, use, and explain the output from the technology. Given that the use of sales forecasts obtained from the AI-based system to determine whether an impairment loss needs to be recorded can have a significant impact on Sanko Foods' financial performance, a self-interest threat to compliance with the principles of Integrity, Objectivity, and Professional Competence and Due Care is created.

Furthermore, factors for Ms. Ito to consider in determining whether reliance on the output of the AI-based system is reasonable include, for example, whether the system was established and effective for the purpose intended; whether the system has been appropriately tested and evaluated for the purpose intended; the appropriateness of the inputs, including data and any related decisions; and her ability to understand the output from the AI-based system in the context in which it is to be used.

Ms. Ito should request Sanko Data to provide further information on the system and its algorithm to exercise professional judgment in applying the conceptual framework in order to make informed decisions about the courses of actions available given the facts and circumstances, and to determine whether such decisions are appropriate in the circumstances. In making this determination, Ms. Ito might consider, for example, whether there is a need to consult with others having relevant expertise or experience (120.5 A5), rather than placing trust in Sanko Data without sufficient justification.

Once Ms. Ito has determined the appropriate course of action, she should also determine if it is appropriate to make her employer aware of any inherent limitations in her professional activities (R113.3). In doing so, she might consider providing sufficient information for Sanko Foods to understand the implications of the limitations.

Professional Competence and Due Care

In complying with the principle of professional competence and due care, the Code requires Mr. Tanaka and the audit engagement team members to: (a) attain and maintain professional knowledge and skill at the level required to ensure that the audit client receives competent professional services based on current technical and professional standards and relevant legislation; and (b) act diligently and in accordance with applicable technical and professional standards (R113.1). Professional competence requires a continuing awareness and an understanding of relevant technical, professional, business and technology-related developments (113.1 A2). In addition, Mr. Tanaka shall, as the engagement partner responsible for the audit engagement, take responsible steps to ensure that the engagement team members working in a professional capacity under his authority have appropriate training and supervision (R113.2).

In this case, the post-acquisition performance of Sanko West Japan has been below initial estimates, and even though an impairment of goodwill would have to be recorded in the current year if historical trends are expected to continue, Sanko Foods has determined that no impairment is required based on the outputs from Sanko Data's AI-based system. In addition to understanding Sanko Foods' intention to change this year's estimation method through introducing the AI-based forecasting system and exercising professional skepticism[1], Mr. Tanaka and his engagement team can comply with the fundamental principle of professional competence and due care by measures such as applying knowledge relevant to Sanko West Japan's industry, business activities, and trends in the local market to properly identify risks of material misstatement (120.16 A2) related to the potential goodwill impairment. In exercising professional skepticism, a critical assessment of the audit evidence includes questioning the reliability and reasonableness of the AI system's outputs, for example, by assessing and evaluating the appropriateness of the inputs to the system, including the data used in any related decisions, as well as the specifications of the algorithm.

Mr. Tanaka should also consider seeking an expert from outside the firm with knowledge of similar AI-based systems to assist with the assessment of Sanko Data's information. Assuming the decision is made to do so, the Code requires Mr. Tanaka to determine whether use of the expert's work is warranted by considering the reputation and expertise of the expert, the resources available to the expert, and the professional and ethics standards applicable to the expert. Such information might be gained from prior association with the expert or from consulting others (320.10 A1).

Considerations in Applying the Conceptual Framework

Professional Judgment

Applying the conceptual framework requires a professional accountant to exercise professional judgment (R120.5(b)) to make informed decisions about the courses of actions available given the facts and circumstances, and to determine whether such decisions are appropriate in the circumstances. In making this determination, the professional accountant might consider, among other matters, whether their expertise and experience are sufficient to reach a conclusion and whether there is a need to consult with others with relevant expertise or experience (120.5 A5).

Bias

Conscious or unconscious bias affects the exercise of professional judgment when identifying, evaluating, and addressing threats to compliance with the fundamental principles (120.12 A1) in using or relying on outputs produced by an AI-based system. Particularly, automation bias might be relevant, which is a tendency to favor output generated from an automated system, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose (120.12 A2).

To mitigate the effect of such bias, Ms. Ito, Sanko Foods' CFO, and Mr. Tanaka, the engagement partner, might consider seeking advice from experts to obtain additional input and/or consulting with others to ensure appropriate challenge as part of the evaluation process. Receiving training related to the identification of bias as part of professional development can also mitigate the effect of bias. (120.12 A3)

1. All professional accountants are required to have an inquiring mind when identifying, evaluating and addressing threats to the fundamental principles. This prerequisite for applying the conceptual framework applies to all accountants regardless of the professional activity undertaken. Under auditing, review and other assurance standards, including those issued by the IAASB, accountants are also required to exercise professional skepticism, which includes a critical assessment of evidence. (120.5 A3)

Both Ms. Ito and Mr. Tanaka should also be aware of the potential for bias in the training data used by Sanko Data when the system was developed and tested and ask Sanko Data staff about their approach for mitigating the effects of such bias[2].

Organizational Culture

Effectively applying the conceptual framework is enhanced when the importance of ethical values aligned with the fundamental principles and other provisions set out in the Code is promoted through the internal culture of the organization (120.13 A1). This is particularly helpful in addressing matters that require significant judgment, such as goodwill impairment. Promoting an ethical culture within Sanko Foods and Yamato Audit Corporation is most effective when, for example, appropriate education and training programs, management processes, and performance evaluation and reward criteria that promote such an ethical culture are in place (120.13 A2(b))

Complex Circumstances[3]

The AI-based system used to make sales forecasts appears to create a complex circumstance because the inputs to the AI incorporate uncertain elements and multiple variables and assumptions that are interconnected and interdependent. It is important for Ms. Ito to ensure that Sanko Data is managing the evolving interaction of these elements, variables and assumptions to mitigate the challenges arising from the circumstance if she is to rely on the system's outputs. Mr. Tanaka should also assess the process used by Sanko Foods in its reliance on the system outputs and, in particular, on Sanko Data's AI-based system. Given the acknowledged lack of professional competence in this area, any assessment of the system might reasonably lead Mr. Tanaka to consider the need to consult with others with relevant expertise or experience as a result of exercising professional judgement in applying the conceptual framework (120.5 A5).

Both Ms. Ito and Mr. Tanaka should also consider the extent to which Sanko Data staff know the rationale for how the AI-based system has arrived at its decisions. Some AI-based systems lack explainability, which increases the risk associated with relying on their outputs[4].

2. For ideas on the importance of managing bias in data and systems, see CPA Canada, ICAS, IFAC & IESBA, *Identifying and mitigating bias and mis- and disinformation* (Toronto: CPA Canada, February 2022), online: https://www.ifac.org/knowledge-gateway/building-trust-ethics/publications/identifying-and-mitigating-bias-and-mis-and-disinformation-paper-3.

3. For the concept of complexity and the importance of managing complexity, see CPA Canada, ICAS, IFAC & IESBA, *Complexity and the professional accountant: Practical guidance for ethical decision-making* (Toronto: CPA Canada, June 2021), online: https://www.ifac.org/knowledge-gateway/building-trust-ethics/publications/ethical-leadership-era-complexity-and-digital-change-paper-1. See also IESBA's February 2022 Exposure Draft, *Proposed Technology-related Revisions to the Code* https://www.ethicsboard.org/publications/proposed-technology-related-revisions-code.

4. See, for example, PricewaterhouseCoopers LLP, *Explainable AI: Driving business value through greater understanding* (PwC, 2018), online: https://www.pwc.co.uk/audit-assurance/assets/explainable-ai.pdf and CPA Canada, ICAS, IFAC & IESBA, *Technology is a double-edged sword with both opportunities and challenges for the accountancy profession* (Toronto: CPA Canada, December 2021), online: https://www.cpacanada.ca/en/foresight-initiative/trust-and-ethics/technology-double-edged-sword.

Scenario B: No Questions Asked

In 2019, after five years of experience in auditing at a major firm, Mark, a professional accountant, wanted to take on a challenge in a new environment and consulted with Kate who had been a close friend from college. Kate advocated for Mark to receive an offer for the position of accounting manager at Oregon System Corporation ("OSC"), a listed company engaged in IT systems development, in which Kate is the general manager of one of OSC's business divisions. Mark received and accepted an employment offer from OSC and started his position that year.

In 2020, with less than a month remaining in the current fiscal year, Mark was feeling concerned about OSC's company-wide sales being slightly below their annual plan, because of the company's incentive structure. Administrative divisions receive a special bonus of one month's salary if the annual sales goal in the company-wide business plan are achieved. Meanwhile, employees in the business divisions would receive a special bonus ranging from 15% to 30% of their base annual salary depending on the achievement of the sales goal of their division, while those business divisions that failed to achieve the plan would receive neither an annual bonus, nor an increase in their base annual salary for the coming year.

OSC's systems record the percentage of completion of each project on a monthly basis. The percentages are then verified by the general managers of each department confirming with customers on the respective projects' progress. According to the sales performance and forecast report a month before the end of 2020, two out of the three business departments are expected to slightly exceed their annual sales goals, but the other ("Department A") is expected to fall short of its goal by about $9 million. Kate's department is the one that is currently forecast below plan and Kate is personally leading the way to achieve the target by taking a more hands-on role in the department's projects. The company-wide forecast is also forecast to be about $7 million below plan.

After year-end, the preliminary sales reported for 2020 showed that OSC's business plan had been achieved and that all business departments had also met their goals, resulting in company-wide bonuses in accordance with the incentive structure.

The sales performance statement for 2020 derived from the system showed that the percentages of completion for some long-term, large-scale projects in Department A had increased by 3% to 5% each month until November, but in December, there had been a 6% increase, which represented a recognition of revenue about $20 million higher than the previous monthly sales trend.

Although these results were inconsistent with the percentage of completion trend, Mark decided not to perform further analysis because he perceived pressure from Kate, and anticipated additional pressure from colleagues in Department A. In addition to such pressure, Mark convinced himself to rely on the sales results shown by the system because he does not have expert knowledge of the system.

Threats to Compliance with Fundamental Principles

Objectivity and Pressure

It is possible that Kate's increased attention to the department's projects is responsible for the surge in the percentage of completion for the month, but threats to compliance with the fundamental principles are created as the questionable figures shown on the system might indicate the possibility of a misappropriation of OSC's assets through inappropriate bonuses being paid out.

In applying the Conceptual Framework, Mark, as a professional accountant in business, is required under the Code to identify, evaluate and address threats to compliance with the fundamental principles (R120.3). Further, in applying the conceptual framework, Mark is required to: (a) have an inquiring mind; (b) exercise professional judgment; and (c) use the reasonable and informed third party test (R120.5).

First, with Mark working in an administrative division, whether he is eligible for a special bonus depends on the company-wide performance result. This creates a self-interest threat to complying with the fundamental principle of objectivity.

This situation might also create an intimidation threat as Mark might be deterred from acting objectively because of the actual or perceived pressures that he is experiencing from Kate, and potentially other colleagues in Department A (120.6 A3 (d) and (e)), to achieve the annual sales goal and receive special bonuses.

Factors that are relevant in evaluating the level of threats created by pressure include:

- The intent of the individual who is exerting the pressure and the nature and extent of the pressure.
- The application of laws, regulations, and professional standards to the circumstances.
- The culture and leadership of the employing organization including the extent to which they reflect or emphasize the importance of ethical behavior and the expectation that employees will act ethically. For example, a corporate culture that tolerates unethical behavior might increase the likelihood that the pressure would result in a threat to compliance with the fundamental principles.
- Policies and procedures, if any, that the employing organization has established, such as ethics or human resources policies that address pressure (270.3 A3).

To address the self-interest and intimidation threats, Mark should likely begin by discussing the matter with Kate to obtain additional information about the higher than expected percentage of completion amounts for December and also to resolve his perceived pressure from her to not follow up on the matter. In the event he is not satisfied with the outcome of the discussion with Kate, he should consider escalating the matter within OSC, explaining any consequential risks to the organization, for example, beginning with more senior members in the accounting group, and then – depending on the outcome, as needed – executive management, internal or external auditors, or those charged with governance

(270.3 A4). Such discussions will help promote an ethical culture within OSC.

Promoting an ethical culture within an organization is most effective when: (a) leaders and those in managerial roles promote the importance of, and hold themselves and others accountable for demonstrating, the ethical values of the organization; (b) appropriate education and training programs, management processes, and performance evaluation and reward criteria that promote an ethical culture are in place; (c) effective policies and procedures are in place to encourage and protect those who report actual or suspected illegal or unethical behavior, including whistle-blowers; and (d) the organization adheres to ethical values in its dealings with third parties (120.13 A2).

Objectivity and Bias

Second, Mark might accept the figures without having an inquiring mind as a result of undue reliance on the system (i.e., automation bias) calculating the percentages of completion, and not wanting to question Kate's confirmations with customers because of their pre-existing relationship and her strong support of his receiving employment with OSC to begin with. The Code requires a professional accountant to comply with the principle of objectivity, which requires Mark to exercise professional judgement without being compromised by bias; conflict of interest; or undue influence of, or undue reliance on, individuals, organizations, or technology (R112.1).

An inquiring mind is a prerequisite to obtaining an understanding of known facts and circumstances necessary for the proper application of the conceptual framework. Having an inquiring mind involves considering the source, relevance and sufficiency of information obtained, taking into account the nature, scope and outputs the system generated (120.5 A1). When considering the source, relevance and sufficiency of information obtained, Mark might consider, among other matters, whether the information or its source might be influenced by the following biases (120.12 A2):

(a) Automation bias, which is tendency to favor output generated from the system even when contradictory information raises questions as to whether such output is reliable.

(b) Confirmation bias, which is a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief. In Mark's situation, if he has convinced himself that the system is correct, he might downplay evidence to the contrary.

To mitigate such biases, Mark might seek advice from experts to obtain additional input and consult with others to ensure appropriate challenge as part of his evaluation process (120.12 A3).

Scenario C: Multipurpose tool

Reiwa, an Osaka-based auditing firm, receives daily accounting journal data from Fujiyama Corporation, an audit client that is not a public interest entity. Reiwa imports the data into an automated audit tool to conduct various analyses such as comparisons with prior periods, comparisons with budgets and analysis of relationships between accounts, as well as analysis of persons who prepare and approve the journal entries. Reiwa uses this tool to conduct the analyses on an annual basis for the annual audit. When an abnormality is identified, the system issues a warning and the audit team conducts detailed analyses based on the warning, and as part of the audit process will report the abnormalities to management. The audit team can set risk scenarios and thresholds in the system to specify abnormalities to be identified.

The management of Fujiyama Corporation is aware that Reiwa is performing these analyses using the audit tool, and believes that if Reiwa does not identify any abnormalities, the company may conclude that no accounting abnormalities or fraud exist. During the 2021 audit, the management of Fujiyama Corporation heard from Ms. Hayashi, a manager on Reiwa's audit team, that no abnormalities were identified in the accounting journal data and, as a result, considered whether Fujiyama Corporation could reduce the number of staff in its Internal Audit Department by half.

The management of Fujiyama Corporation advised Ms. Hayashi that they were considering downsizing the Internal Audit Department and requested her to share the analyses data from the audit tool. When Ms. Hayashi explained that access to the detailed analytical outputs of the audit tool was limited to members of Reiwa's audit team, the management of Fujiyama Corporation proposed that Reiwa could provide a non-assurance service where Fujiyama Corporation could purchase or license the tool and conduct analyses of the daily accounting journal data themselves outside of Reiwa's work.

Threats to Compliance with the Fundamental Principles, and to Independence

Professional Competence and Due Care

Maintaining professional competence as a professional accountant requires a continuing awareness and an understanding of relevant technical, professional, business and technology-related developments (113.1 A2). In addition, there may be inherent limitations in the nature of the professional services or activities provided by professional accountants. The Code requires that where appropriate, a professional accountant make clients, the employing organization, or other users of the accountant's professional services or activities, aware of the limitations inherent in the services or activities (R113.3).

Specifically, in this case, the audit tool identifies abnormalities by using automated, statistical methods applied to client data. It contributes not only to enhancing audit effectiveness, but also improving the efficiency and timeliness of audit work. It might not, however, be capable of detecting all types of fraud and errors, and it should be used for its intended purpose.

In order to use the tool properly, Ms. Hayashi and other audit team members need to understand the analytical/statistical methods used in the tool, as well as the client's business and accounting practice, and consider the risk that the tool does not work as expected. A self-interest threat to compliance with the principles of objectivity and professional competence and due care might be created, however, if Ms. Hayashi and other audit team members allow themselves to be unduly reliant on the tool, hence compromising their exercise of professional or business judgement (R112.1) to use the tool properly or if they do not understand the tool sufficiently and do not prioritize gaining competence through education and experience (230.3 A2)[5]. In such instances, examples of actions that Ms. Hayashi and team members can take to address such a self-interest threat include obtaining assistance or training from someone with the necessary expertise (230.3 A4), seeking advice from experts to obtain additional input and consulting with others to ensure appropriate challenge as part of the evaluation process (120.12 A3) and ensuring sufficient oversight.

Where appropriate, Ms. Hayashi should inform the management, or if appropriate those charged with governance, of Fujiyama Corporation of any limitations inherent in the tool (R113.3).

Independence

Professional accountants are required to be independent when performing audits, reviews, and other assurance engagements. Independence is linked to the fundamental principles of objectivity and integrity, and comprises independence of mind and independence in appearance (120.15 A1).

If Reiwa provides a non-assurance service by selling/licensing the tool to Fujiyama Corporation, a self-review threat to independence might be created, depending on how Reiwa will use the outputs of the tool. The Code requires that, in considering whether to provide such a non-assurance service to Fujiyama Corporation, Reiwa determine whether the provision of the service might create

5. Although Ms. Hayashi is a professional accountant in public practice, she is performing professional activities pursuant to her relationship with the firm, so she must also comply with the provisions in Part 2 of the Code that apply to her circumstances (R120.4).

a self-review threat by evaluating whether there is a risk that (a) the results of the service will form part of or affect the accounting records, the internal controls over financial reporting, or the financial statements on which the firm will express an opinion, and (b) in the course of the audit of those financial statements on which the firm will express an opinion, the audit team will evaluate or rely on any judgments made or activities performed by the firm when providing the service (R600.14).

In order to identify and evaluate threats that might arise from providing the proposed non-assurance service to Fujiyama Corporation, consideration should be given to, among other factors: the nature, scope, intended use and purpose of the service; the nature and extent of the impact of the service, if any, on the systems that generate information that form a significant part of Fujiyama Corporation's internal controls over financial reporting; and whether, and the extent to which, the outcome of the service will affect the accounting records or matters reflected in the financial statements on which the Reiwa will express an opinion (600.9 A2).

Considerations in Applying the Conceptual Framework

Prohibition on Assuming Management Responsibilities

The threats to independence described above also relate to concerns regarding the assumption of management responsibility by the firm. The Code prohibits a firm or a network firm from assuming a management responsibility for an audit client (R400.13). Determining whether an activity is a management responsibility depends on the circumstances and requires exercising professional judgment. Examples of activities that would be considered a management responsibility include taking responsibility for designing, implementing, monitoring or maintaining internal control (400.13 A3). The Code requires that when performing a professional activity for an audit client, the firm be satisfied that client management makes all judgments and decisions that are the proper responsibility of management (R400.14). This includes ensuring that the client's management provides oversight of the activities and evaluates the adequacy of the results of the activities performed for the client's purpose, and accepts responsibility for the actions, if any, to be taken arising from the results of the activities.

In the scenario, Fujiyama Corporation's management is considering whether to decrease the number of staff in the Internal Audit Department by half as a result of the fact that the tool used by Reiwa did not identify any abnormality in the accounting data. This implies that the audit tool (and by extension, the auditor) could serve an internal audit role for Fujiyama Corporation.

If the firm provides a non-assurance service (i.e., internal audit service) for Fujiyama Corporation, the Code requires the firm to be satisfied that:

(a) The client designates an appropriate and competent resource, who reports to those charged with governance, to:
   (i) Be responsible at all times for internal audit activities; and
   (ii) Acknowledge responsibility for designing, implementing, monitoring and maintaining internal control;

(b) The client reviews, assesses and approves the scope, risk and frequency of the internal audit services;

(c) The client evaluates the adequacy of the internal audit services and the findings resulting from their performance;

(d) The client evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process; and

(e) The client reports to those charged with governance the significant findings and recommendations resulting from the internal audit services (R605.3).

Providing the proposed non-assurance internal audit service by using the tool or selling/licensing the tool to Fujiyama Corporation increases the possibility that Reiwa is assuming a management responsibility (605.3 A1 and 605.4 A1). The firm would need to be able to ensure that the proposed non-assurance service or sale/licensing of the tool is not involved with taking responsibility for designing, implementing, monitoring and maintaining internal control for the client (605.3 A2), which seems very unlikely, especially if the firm is also continuing to use the tool as part of the external audit.

Scenario D: Aurora seeks a brighter future

The consulting division of Aurora, a mid-sized accounting firm, provides advisory services for implementing IT systems. In recent years, as price competition for non-assurance services between competitors has intensified and the level of audit fees has stagnated, Aurora is facing heightened business risks such as existing clients shifting their business to competing firms, difficulty in acquiring new clients, and pressure from clients to lower fees.

Due to the deterioration of its financial condition, Aurora obtained a bank loan a couple of months ago to address its operating cash flow needs. The loan agreement contains a financial covenant that requires Aurora to maintain positive net assets at the end of each quarter. The amount of net assets at the end of last quarter was only slightly positive and there is a significant possibility that the net assets will become negative in the next quarter if Aurora is unable to obtain new advisory or audit engagements and/or make sufficient cost reductions. Aurora's management is reluctant to make any new capital investments.

Mr. Kim, a professional accountant, is Aurora's VP of Finance and is in charge of the firm's accounting, finance and general affairs. His responsibilities include the administration associated with new engagements.

Mr. Kim was recently notified that Aurora had received a proposal for a significant IT systems implementation advisory engagement from Venus. Venus is a cosmetic goods manufacturer targeting consumers in their 20s and 30s, and is expanding its business due to its strong performance. If Aurora successfully obtains the engagement, the firm's business performance would be expected to stabilize and its net assets should remain positive for the next three years.

Two months before the proposed start of the engagement, Venus asked Mr. Kim to respond to a questionnaire about the internal controls over information security at Aurora. In order to minimize the risk of information leaks, Venus requires its business partners to have a robust information security system. Although Aurora will not generally retain confidential client information in its internal systems as part of the implementation advisory engagement, Venus nevertheless requires a written guarantee that the requirements have been met by all business partners. As Aurora has not made an investment in its information security system for a couple of years, there is a strong probability that the system will need a significant investment in order to meet Venus' stringent requirements.

Mr. Kim consulted with the firm's COO who indicated that the firm has not experienced any security breaches over the past three years; that Venus' requirements were "over the top"; and the firm could not afford to invest in all of the system improvements necessary to ensure that Aurora meets Venus' requirements. The COO also indicated that considering the current business situation, the firm could not miss this opportunity with Venus.

Threats to Compliance with the Fundamental Principles:

Integrity and Objectivity

The Code requires a professional accountant to comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships (R111.1). Integrity involves fair dealing, truthfulness and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organizational consequences (111.1 A1). Acting appropriately involves standing one's ground when confronted by dilemmas and difficult situations or challenging others as and when circumstances warrant, in a manner appropriate to the circumstances (111.1 A2).

In addition, the Code requires a professional accountant to comply with the principle of objectivity, which requires an accountant to exercise professional or business judgment without being compromised by bias, conflict of interest or undue influence of, or undue reliance on, individuals, organizations, technology or other factors (R112.1). The Code further requires a professional accountant not to undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity (R112.2).

In this case, the most urgent task for Aurora's management is to maintain positive net assets to avoid violating the financial covenants of the new loan. As a result, there is significant pressure on Aurora to obtain the engagement with Venus. Aurora does, however, need to make investments in its information security system to ensure that its system meets Venus' requirements.

Although Mr. Kim is a professional accountant working in a public practice firm, he is performing professional activities pursuant to his role with the firm, so he must comply with the provisions in Part 2 of the Code that apply to his circumstances (R120.4). For example, he cannot allow pressure from others to result in a breach of compliance with the fundamental principles (R270.3(a)). A professional accountant might face pressure that creates threats to compliance with the fundamental principles, for example an intimidation threat, when undertaking a professional activity. Pressure might be explicit or implicit and might come from within the employing organization, for example, from a colleague or superior (270.3 A1). A corporate culture that tolerates unethical behavior might increase the likelihood that the pressure will result in a threat to compliance with the fundamental principles (270.3 A3).

In this case, being pressured by the COO, Mr. Kim might be tempted to provide inaccurate responses to Venus because if Venus does not test Aurora's system and simply relies on Aurora's assertion that the system meets the requirements, Aurora will qualify for the engagement. Intimidation and self-interest threats to the principles of integrity and objectivity are likely because it appears that Mr. Kim is being pressured by the COO to obtain the proposed engagement with Venus. Note that whereas the COO's statement that Aurora has not experienced a security breach in the past three years is possible, it is both difficult to prove and not the primary consideration as Venus has specific security requirements that are clearly beyond Aurora's current capacity.

Mr. Kim is required to comply with the principles of integrity and objectivity in dealing with the situation. Discussing the circumstances creating the pressure and consulting with others about those circumstances might assist Mr. Kim's evaluation of the level of threat. Such discussion and consultation, which requires being alert to the principle of confidentiality, might include:

- Discussing the matter with the individual who is exerting the pressure to seek to resolve it.
- Escalating the matter within the employing organization, including when appropriate, explaining any consequential risks to the organization, for example with:
  – Higher levels of management.
  – Internal or external auditors.
  – Those charged with governance (270.3 A4).

If the COO and, where appropriate, those charged with governance, are not supportive of acting appropriately to resolve the issue and the pressure continues, or if another member of the firm's management team decided to complete the questionnaire in a false or misleading manner, Mr. Kim would need to consider whether the situation constitutes non-compliance with laws and regulations. In this case, such non-compliance would not have a direct effect on the determination of the amounts and disclosures in Aurora's financial statements, but compliance might be fundamental to the operating aspects of Aurora's business, to its ability to continue its business, or to avoid material penalties (260.3(b)).

If he concludes that non-compliance has occurred after obtaining an understanding the matter (R260.12) and assessing the appropriateness of the response of the superiors and those charged with governance (R260.16), he might determine if further action is needed in the public interest (R260.17), including disclosing the matter to an appropriate authority (260.18 A1). Ultimately, he might need to determine whether he would need to resign from Aurora (260.18 A2).

Scenario E: Risks at Sunrise

Sakura, a large audit firm in Japan, plans to differentiate itself from other audit firms by using advanced analytics tools in its audit procedures and having internal analytics experts be actively involved to enhance risk assessment procedures and substantive tests, and to better analyze client data. The firm considers these analytics tools of high strategic importance to improve the quality of audit services it provides.

Sunrise Corporation, which is a well-established, listed company in the food services industry, has been an audit client of Sakura for many years. In 2021, in accordance with the firm's policy of promoting analytics, the audit team started to use the analytics tools newly developed by the firm. As a result of using the tools, the audit team gained a better understanding of the accounts and their relationships with other quantitative and qualitative information. However, the resulting risk assessments themselves did not change significantly from the previous year. The engagement partner believes that it is appropriate to increase the audit fee by approximately 10% in light of the large amount of time and cost associated with using the new tools required for the more sophisticated risk assessment procedures.

Although Sunrise appreciated Sakura's use of the analytics tools and internal experts that provide a more sophisticated risk assessment, the company is reluctant to accept an audit fee increase as a result. Instead, Sunrise has requested that the audit fee be decreased because of the efficiencies that should be achieved by adopting the technology-based risk assessment procedures.

As the food services industry is highly competitive and the economic environment surrounding Sunrise is highly volatile, the audit team would like to continue using the new analytics tools and the firm's internal analytics experts in the 2022 audit to further strengthen the risk assessment process.

The engagement partner and the firm's management are discussing how to respond to the request from Sunrise about the audit fee. Specifically, they are considering not using the tools and additional staff to keep the costs unchanged, or using the tools and analytics staff but without raising the audit fee. There had been an increase in auditor turnover due to high audit fees in recent years and they know there is a possibility of losing Sunrise if they raise the audit fee.

Threats to Compliance with the Fundamental Principles, and to Independence

Professional Competence and Due Care

To comply with the principle of professional competence and due care, the Code requires a professional accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service (R113.1). If the firm decides to stop using the analytics tools to keep the audit fee/costs unchanged, the engagement partner and the firm's management need to consider whether Sunrise will still receive competent professional service.

Objectivity

The Code requires a professional accountant to comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of, or undue reliance on, individuals, organizations, technology or other factors (R112.1). Sakura and the members of the audit team for the Sunrise audit should make decisions without being overly influenced by the importance of Sunrise as an audit client and without overly depending on results obtained from the analytics tools or the firm's analytics experts.

The firm and the engagement partner are concerned about losing the audit client if they increase the audit fee. In addition, the firm has been providing audit services to the client for many years and the client is a well-established, listed company. These facts might create familiarity and intimidation threats to complying with the principle of objectivity. If Sakura keeps the fee unchanged and continues to use the tools at the firm's expense, the firm might face self-interest threats created by the level of the audit fee paid by the audit client.

Independence

The fear of losing the client might create threats to complying with independence (and the principle of integrity). The Code requires a firm performing an audit engagement to be independent (R400.11) and apply the conceptual framework to identify, evaluate and address threats to independence in relation to an audit engagement (R400.12).

Considerations in Applying the Conceptual Framework

Public Interest Entity

Given that Sunrise is a public interest entity, stakeholders of the company have heightened expectations regarding Sakura's independence (410.3 A2) and the level of the identified threats might be perceived to be higher (300.7.A3). When the audit engagement team evaluates the level of self-interest and intimidation threats, this needs to be taken into consideration.

Level of Audit Fee

Determining the audit fee to be charged to an audit client is a business decision of the firm taking into account the facts and circumstances relevant to that specific engagement (410.5 A1). In evaluating the level of self-interest and intimidation threats created by the amount of audit fee paid by Sunrise, Sakura might consider the firm's commercial rationale for the audit fee and whether undue pressure has been, or is being, applied by Sunrise to reduce the audit fee (410.5 A2).

A factor that is relevant in evaluating the level of threats created when fees for an audit or any other engagement are paid by the audit client is consideration of the operating structure and the compensation arrangements of the firm and network firms (410.4 A3).

Examples of actions that might be safeguards to address such threats include:

- Having an appropriate reviewer who does not take part in the audit engagement assess the reasonableness of the fee proposed, having regard to the scope and complexity of the engagement.
- Having an appropriate reviewer who did not take part in the audit engagement review the work performed. (410.5 A3)

If the circumstances that created the threats cannot be eliminated and safeguards are not available or capable of being applied to reduce the threats to an acceptable level, it would be appropriate for Sakura to decline or end providing the audit service to Sunrise (R120.10).

Fee Dependency

If the total fees generated from Sunrise represent a large proportion of the total fee revenue of Sakura, the dependence on, and concern about the potential loss of, fees from audit and other services provided to Sunrise impact the level of self-interest threat and create an intimidation threat (410.14 A1). In evaluating the level of such self-interest and intimidation threats, Sakura might consider the operating structure of the firm and whether the firm is expected to diversify such that any dependence on the audit client is reduced (410.14 A3).

Examples of actions that might be safeguards to address such threats include:

- Having an appropriate reviewer who is not a member of the firm review the audit work.
- Reducing the extent of services other than audit provided to the audit client.
- Increasing the client base of the firm to reduce dependence on the client.
- Increasing the extent of services provided to other clients. (410.14 A4)

In addition, if the fees generated from Sunrise represent a large proportion of the revenue of one partner or one office of the firm, a self-interest or intimidation threat is created (410.14 A5) and would need to be addressed.

Scenario F: Miyabi mistake?

In October 2019, Miyabi Accounting Corporation ("the firm"), a mid-sized accounting firm, was engaged by Sato Chemical Corporation, a listed company (a public interest entity) that was not an audit client to develop fraud detection software. The software detects signs of fraud by using financial data (general account data, inventory, purchases, delivery amounts, etc.) and non-financial data (number of personnel, timing of journal entries, person responsible for the journal entries, attendance and leaving time of the accounting staff, etc.) as inputs, taking into account fraud instances disclosed in the past.

In December 2019, the software was completed. The engagement agreement included no subsequent licensing fees, and Sato Chemical accepted responsibility for updating and maintaining the software after implementation. In conducting an acceptance inspection of the software, Sato Chemical input sample data into the software, including data related to past known fraud instances, and successfully detected those cases. As a result, the software was implemented in Sato Chemical's accounting department.

The accounting department, which is in charge of preparing the group's financial statements, has been inputting subsidiaries' accounting and financial data and related non-financial data into the software semi-annually since January 2020 in order to detect signs of fraud in the subsidiaries. The effectiveness of the software is tested annually by Sato Chemical staff and was last verified at the end of December 2020.

In September 2021, Sato Chemical approached Miyabi Accounting Corporation for audit services for its next fiscal year. Prior to the engagement being accepted, fraudulent transactions were identified at Sato Plastic Corporation, a subsidiary of Sato Chemical, based on a whistle-blowing report from an employee of Sato Plastic. The fraudulent transactions had not been detected by the software.

Ms. Takada, a partner of Miyabi Accounting Corporation, is considering the implications of the software failing to detect the fraud, and whether or not to accept the audit engagement for the fiscal year 2022.

Threats to Compliance with the Fundamental Principles, and to Independence

Self-review Threat and Period During which Independence is Required

As Sato Chemical is a listed company (a public interest entity) and Miyabi Accounting Corporation has provided a non-assurance service that creates a self-review threat, the firm should not accept the appointment as auditor unless the provision of the service ceases before the commencement of the audit engagement period or the firm takes action to address any threats to its independence, and the firm determines that, in the view of a reasonable and informed third party, any threats to the firm's independence have been or will be eliminated or reduced to an acceptable level (R400.32).

Actions that might be regarded by a reasonable and informed third party as eliminating or reducing to an acceptable level any threats to independence created by the provision of non-assurance services to a public interest entity prior to appointment as auditor of that entity include:

- The results of the service had been subject to auditing procedures in the course of the audit of the prior year's financial statements by a predecessor firm.
- The firm engages a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, to perform a review of the first audit engagement affected by the self-review threat consistent with the objective of an engagement quality review.
- The public interest entity engages another firm outside of the network to:
  (i) Evaluate the results of the non-assurance service; or
  (ii) Re-perform the service, to the extent necessary to enable the other firm to take responsibility for the result of the service (400.32 A1).

Given the circumstances, including that fraudulent transactions had not been identified by the software, the situation would require careful consideration. Even if the use of the fraud detection software ceased before commencement of the audit engagement period, the output of such software in past periods had formed part of or affected the accounting records, the internal controls over financial reporting, and the financial statements on which the firm will express an opinion. This might make it less likely that safeguards are available to eliminate or reduce to an acceptable level the threats to independence.

For example, Sato Chemical's internal controls over fraud (including the results of the fraud detection software) would have been subject to auditing procedures in the course of the audit of the prior year's financial statements by a predecessor firm. Whether such action is regarded by a reasonable and informed third party as eliminating or reducing to an acceptable level any threats to independence might include consideration of the materiality levels and nature of fraud that was undetected by the software.

Furthermore, assuming the fraud detection issue is rectified and the software continues to be used by Sato Chemical, a self-review threat is created. The Code prohibits a firm from providing a non-assurance service to an audit client that is a public interest entity if the provision of that service might create a self-review threat in relation to the audit of the financial statements on which the firm will express an opinion (R600.16).

Self-interest Threat and Conflicts of Interest

When investigating the issue of the software failing to detect the fraud, a potential conflict of interest exists between Miyabi Accounting Corporation and Sato Chemical regarding the responsibility for the software that has failed to detect the fraud. For example, was the failure to detect the fraud due to ineffective acceptance, annual testing, or updating/maintenance of the software after purchase by Sato Chemical? Or was it due to an inherent issue within the software developed by Miyabi Accounting Corporation?

Although Sato Chemical is responsible for updating and maintaining the software after purchase, Miyabi Accounting Corporation should clarify whether the failure to detect the fraud was not caused by a malfunction of the software. For example, the firm should clarify whether it was not possible to detect the fraud that had occurred in Sato Plastic because it was of a different nature from the fraud cases used in the development of the software or whether the type of fraud was not included in the scope of the verification of the software because the fraud took place after October 2019, when the software was developed.

The Code requires a professional accountant not to allow a conflict of interest to compromise professional or business judgment (R310.4), as it creates threats to compliance with the principle of objectivity and might create threats to compliance with the other fundamental principles (310.2).

A self-interest threat is created if there is a possibility that the cause of the failure to detect the fraud is due to an inherent issue in the software developed and sold by Miyabi Accounting Corporation. This self-interest threat compromises compliance with the fundamental principles of integrity and objectivity because the firm has an incentive to avoid blame, or reputational damage, for the malfunction of the software.

Therefore, it is necessary to apply appropriate safeguards to address the self-interest threat created to reduce the threat to an acceptable level. An example of appropriate safeguards includes having someone other than Ms. Takada and those who were involved in selling the software to Sato Chemical be in charge of addressing the issue of the software failing to detect the fraud.

In this situation, the firm might also need to consider whether the software should be improved. In addition, in relation to legal liabilities arising from the malfunction of the software, the firm might seek to obtain legal advice.

Other Potential Threats and Client Acceptance

Ms. Takada should comply with the fundamental principles and apply the conceptual framework to identify, evaluate and address threats when considering the acceptance of a new client relationship with Sato Chemical (320.1).

Acceptance of a new client relationship with Sato Chemical by Miyabi Accounting Corporation might create a threat to compliance with one or more of the fundamental principles (320.2). Threats to compliance with the principles of integrity or professional behavior might be created, for example, from questionable issues associated with the client (its owners, management or activities). Issues that might, if known, create such a threat include client involvement in illegal activities, dishonesty, questionable financial reporting practices or other unethical behavior (320.3 A1). To comply with the fundamental principles, Ms. Takada needs to consider the appropriateness of accepting an audit engagement; for example, if:

- It is determined that the cause of the failure to detect the fraud is due to an update or maintenance of the software by Sato Chemical. In this circumstance, the company may attempt to shift the blame to Miyabi Accounting Corporation, which would indicate a lack of integrity at the company.
- Sato Chemical files a lawsuit against Miyabi Accounting Corporation for the software failing to detect the fraud. Self-interest and intimidation threats might be created because the company and the firm are placed in an adversarial position. Such adversarial positions might affect management's willingness to make complete disclosures whereas the relationship between client management and the firm must be characterized by complete candor and full disclosure regarding all aspects of a client's operations (430.3 A1).

In applying the conceptual framework when determining the appropriateness of accepting an audit engagement, factors that are relevant in evaluating the level of the threats include: knowledge and understanding of the client, its owners, management and those charged with governance and business activities; and the client's commitment to address the questionable issues, for example, through improving corporate governance practices or internal controls (320.3 A2).

Scenario G: Dark Side of la Luna

After six years of experience auditing financial institutions as a professional accountant at an auditing firm, Claudia moved to the risk assessment division of Banco de la Luna (the "Bank"), a major Mexican financial institution. For the past 10 years, the Bank has been using a risk assessment system developed by and purchased from Esperanza, an independent system vendor, but recent system evaluation results showed that the system has become obsolete and no longer reflects the actual economic environment. The Bank decided to renew the system.

After receiving proposals from several system vendors including Esperanza, the Bank selected a new system developed by Esperanza. Claudia, who was assigned to participate in the project team implementing the new system, was responsible for verifying the data used in the legacy system that would be transferred to the new system.

Claudia began to examine the legacy system's data and noticed discrepancies between some of the input information and the expected outputs in past years. As Claudia is not a system expert, she discussed the matter with a technical representative of Esperanza. In the discussion, the representative said, "The system is used by many other customers and we have never heard of such a complaint. There should be nothing wrong with the system. It's just a matter of your customization." He denied any problem with the current system.

Claudia consulted with Fernando, her supervisor, and he told her, "Esperanza is right, there is no problem with the current system. Anyway, the new system will be introduced soon, so there is no need for further investigation." Claudia knew that Fernando had been working for Esperanza before he moved to the Bank.

Claudia believes that the potential anomaly in the legacy system should be seriously considered, because the results of the system will be used as reference values for the valuation of assets and liabilities in the Bank's financial statements, and will also serve as important indicators in management decisions regarding risk assessment. Claudia does not, however, have enough technical knowledge in this area to determine if the problem she noted is really a systemic one or not.

Threats to Compliance with Fundamental Principles

Professional Competence and Due Care and Pressure

In complying with the principle of professional competence and due care, Claudia is required under the Code to attain and maintain professional knowledge and skill at the level required to ensure that the Bank receives competent professional services (R113.1). Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional, business and technology-related developments (113.1 A2). Claudia, as a professional accountant, is required under the Code to identify threats to compliance with the fundamental principles (R120.6) in applying the Conceptual Framework.

First, an intimidation threat to compliance with the principle of professional competence and due care might be created by Fernando, who is a former employee of Esperanza and might be trying to protect Esperanza or himself (200.6 A1). For example, Claudia might be facing pressure from Fernando to act unethically, including pressure to suppress adverse findings and pressure to act without sufficient expertise or due care (270.3 A2).

In this regard, she might discuss the matter with Fernando to resolve the issue of the pressure from him. Furthermore, she might consider escalating the matter within the Bank to higher-level management, for example, explaining any consequential risks to the organization (270.3 A4). In doing so, it may be important for Claudia to discuss with management the culture and leadership of the Bank including the extent to which they reflect or emphasize the importance of ethical behavior and the expectation that employees will act ethically (270.3 A3). In particular, in the context of this scenario, a corporate culture that tolerates unethical behavior might increase the likelihood that pressure would result in a threat to compliance with the fundamental principles. Such discussion will help promote an ethical culture within the Bank. Even if Claudia is not in a senior position, taking these ethical actions will demonstrate her ethical leadership. Finally, as guided by the Code, Claudia is encouraged to document these actions (270.4 A1).

In addition, she needs to consider how she should act in the public interest. Although Claudia has a responsibility to further the legitimate objectives of the Bank, she cannot allow her actions to compromise compliance with the fundamental principles (200.5 A1). It is notable that a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest (100.1).

Second, a self-interest threat might be created because:

- Performing further investigation on the identified anomaly in the correlation between the input data and expected outputs generated by the legacy system would require considerable additional work (200.6 A1 (a)). The threat might prevent her from applying due care or complying with the principles of objectivity or professional behavior. In addition, from her perspective as a Bank employee, a self-interest threat might be created if the further investigation and correction of any misstated amounts negatively impacted the Bank's financial statements, and potentially any incentives tied to performance.

- It might be difficult for her to fully understand the system because she is not a technology expert, yet Claudia needs to sufficiently understand the current system in order to perform her professional activity competently. In this regard, she can consider whether there is a need to consult with others with relevant expertise or experience (120.5 A5). Claudia is required under the Code to have an inquiring mind when she applies the Conceptual Framework (R120.5(a)), recognizing that her understanding of the system is limited. She also needs to make the Bank aware of the limitations inherent in her activities, as appropriate. (R113.3).

The Code requires Claudia to evaluate whether the identified threats are at an acceptable level (R120.7). The evaluation of the threats might be impacted by the work environment within the Bank and its operating environment (200.7 A3). Among other things, such environmental factors include policies and procedures to empower and encourage employees to communicate ethics issues that concern them to senior levels of management without fear of retribution. She might consider obtaining legal advice where she believes that unethical behavior or actions by others have occurred or will continue to occur within her employing organization (200.7 A4). Also, where appropriate, it might be valuable for her to consult with her professional accountancy body in such a difficult situation, where a confidential ethics advisory service is provided by the body.

Given the importance of the accuracy of the data being transferred from the legacy system to the newly developed system – given that this data forms the basis of the new system – Claudia is unlikely to assess the threats identified as being at an acceptable level.

Integrity

To comply with the principle of integrity, Claudia should have the strength of character to act appropriately even when faced with pressure to do otherwise or when taking an appropriate action might have adverse consequences for her or the Bank (111.1 A1). In this scenario, Claudia is responsible for preparing and providing information and is also responsible for acting with expertise. Inappropriately responding to the pressure she is facing from Fernando might lead to reporting misleading financial results or misstating income (270.3 A2).

Other Considerations: Non-Compliance with Laws and Regulations (NOCLAR)

Data accuracy is crucial to the Bank's financial information as well as to management decisions. Since Claudia is responsible for verifying the data used in the legacy system that is being transferred to the new system, she might encounter or be made aware of suspected non-compliance with laws and regulations in relation to the heavily regulated banking industry, which might lead to material penalties for the Bank (260.3).

Under such circumstances, she once again needs to bear in mind that a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest (260.4). If protocols and procedures exist within the Bank to address such suspected non-compliance, she should consider them in determining how to respond to the suspected non-compliance (R260.9). As an accountant that is not a senior professional accountant, Claudia should seek to obtain an understanding of the nature of the suspected non-compliance and the circumstances in which it has occurred or might occur (R260.24). However, as she is not an IT systems expert, she might have difficulty in evaluating the impact of the anomalies she has identified within the legacy system data (i.e., the suspected non-compliance with laws and regulations). As a result, she should consider consulting, on a confidential basis, with others in the Bank (such as IT staff), her professional body, or legal counsel (260.24 A2).

In addition, Claudia, who is not a senior professional accountant, should inform her superior. However, as Fernando, her immediate superior, appears to be involved in the matter, she should inform the next higher level of authority within the Bank (R260.25). In case she cannot resolve the issue by taking these actions, she might consult with those charged with governance within the Bank.

In exceptional circumstances, she might consider whether disclosure of the matter to an appropriate authority, such as the prudential supervisor of the Bank, is an appropriate action (R260.26).

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