

ETHICS EDUCATION TOOLKIT

SCENARIO FOUR NO CONTROL

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SCENARIO FOUR: NO CONTROL

Participants

John Lim Internal Auditor
Adam Smith Internal Audit Manager

Setting the Scene

(Use this paragraph as an introduction before the video is shown)

John, a young chartered accountant and one of a number of internal auditors working for a large organization, has been assigned a range of specific projects in the last 12 months. John's role in these projects has been to complete a specific work program and draft a report for review by Adam Smith.

Facts of the Case

In completing the work program, John finds a number of items that concern him. The audit programs don't require follow up or investigation of these items; however, John can't help himself. He believes in his role as internal auditor and proceeds to investigate the items. The items of concern relate to inventory controls and cash. John aims to find out the facts before raising the matter further with Adam Smith.

John documents his findings. At a workshop inspection, he notices that controls over inventory requisitions are poor, leading to serious concerns over the accuracy of financial records. Although the organization is large, the potential for material differences worries John. During another audit, he finds cash records are incomplete and funds missing. John raises his findings with the individual responsible who is unable to provide a satisfactory explanation.

John completes his draft report ready for Adam's review. Adam is disturbed by John's findings and is unhappy with John for pursuing items outside of the audit program. Adam tells John not to concern himself further with the matters he found and that he (Adam) will take the appropriate action.

In the draft monthly report of audit activity prepared for senior management, John notices that Adam has not raised his findings at all. Concerned at the omission, John confronts Adam who reminds him of the earlier discussion. John is uncertain of what his next steps should be.

Suggested Discussion Points

1. What are the relevant facts?
2. What are the ethical issues?
3. Who are the primary stakeholders?
4. What are the possible alternatives?
5. What ethical issues arise from these alternatives?
6. What are the practical constraints?
7. What actions could be taken?
8. Could the situation have been approached differently? If so, how?

Discussion

Issues for discussion include:

- Loyalty to immediate manager and to the organization;
- Role of internal auditor;
- Responsibility to the shareholders/owners;
- Dealing with ethical issues outside the framework of a code of ethics, or other established company procedures; and
- Consideration of Adam Smith's role based on two alternative scenarios:
 - 1) that he is actively involved in covering up deficiencies in internal audit procedures; and
 - 2) that he has investigated John's concerns and found that they do not warrant further action.

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Application of American Accounting Association 7 Step Model

1. DETERMINE THE FACTS

What? Who? Where? When? How?

What do we know or need to know, if possible, that will help define the problem?

- John, a young chartered accountant, is an internal auditor responsible for specific projects.
- In completing his work, John discovers matters of concern that relate to inventory and cash controls. John aims to find out the facts before raising the matter with Adam Smith (Internal Audit Manager).
- John documents his findings, noting inventory controls were poor, cash records incomplete and funds missing.
- John raises issue with individual responsible and gets an unsatisfactory explanation.
- John completes his report for Adam's review. Adam is angry that John has conducted reviews beyond his brief. However, he advises John that he will raise the issues in the monthly management report.
- John subsequently discovers that Adam has not included his findings in the monthly management report.

2. DEFINE ETHICAL ISSUES

List the significant stakeholders. Define the ethical issues.

Make sure what precisely the ethical issue is (for example, Conflict involving rights, questions over limits of an obligation, etc).

a) List all stakeholders

- John Lim
- Adam Smith
- The company - its shareholders and creditors
- Individual responsible for cash/inventory control

b) Identify the ethical issues

- John's responsibility to Adam Smith versus his personal integrity
- John's responsibility to the company and its shareholders versus his responsibility to Adam Smith
- John's relationship with the individual responsible for case/inventory control versus his duty to the company

c) Discuss the ethical threats

- There is an ethical threat of self-review in that John discovers that the internal audit function is under threat as it fails to correct the errors which it has discovered and that Adam Smith is permitting inconsistencies to be under cover in the review process;
- John is also faced with the ethical threat of advocacy and intimidation as John is expected to advocate and support Adam Smith and the weak cash/inventory system; he is also intimidated, as he does not have the support of his peers or his superiors for investigating something suspicious.

3. IDENTIFY THE MAJOR PRINCIPLES, RULES, VALUES

(For example: integrity, quality, respect for persons, profit)

- Professional competence (John's responsibility as a chartered accountant)
- Technical Standards (John and Adam should carry out their professional work in accordance with technical and professional standards relevant to that work)
- Integrity (Adam should be straightforward)

4. SPECIFY THE ALTERNATIVES

List the major alternative courses of action, including those that represent some form of compromise or point between simply doing or not doing something.

- John can do nothing
- John can try to raise his concerns with management, his peers, the audit committee
- John can resign
- John can raise his concerns informally with the external auditors

5. COMPARE VALUES AND ALTERNATIVES - SEE IF CLEAR DECISION

Determine if there is one principle or value, or combination, which is so compelling that the proper alternative is clear. (For example, correcting a defect that is almost certain to cause loss of life).

Note: See how many of the group will move to a decision at this point based on the force or strength of a norm or principle. Regardless of whether a decision is reached, work through **steps 6 and 7**.

6. ASSESS THE CONSEQUENCES

Identify the short and long run, positive and negative consequences for the major alternatives. The common short run focus on gain or loss needs to be measured against the long run considerations. This step will often reveal an unanticipated result of major importance.

John can do nothing

- This action will pacify Adam
- Could have detrimental financial consequences on the company if there are continual losses of inventory/cash
- John could breach his ethical standards as outlined by the Code of Ethics for Professional Accountants

John could raise concerns with management/peers/audit committee

- May highlight problems within the company and lead to its rectification
- May result in action being taken against the employee who has failed to keep adequate cash/inventory records
- Could have a negative impact on John's career aspirations if he has to continue working with Adam
- Alternatively, John may be rewarded for identifying the problems

John can talk informally to the external auditors

- May preserve John's professional integrity
- May lead to an independent investigation
- Could have a negative impact on John's career aspirations if he is identified as the source

John can resign

- may preserve John's professional integrity
- may not result in problem being identified, which may have detrimental effects on the company

7. MAKE YOUR DECISION

Balance the consequences against your primary principles or values and select the alternative that best fits.

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