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Ethics in Finance

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Abstract

The ethical standards are becoming increasingly important in the finance area. Whether we talk about the accounting profession, audit or investment areas, the business organizations are struggling to conform to the generally accepted ethical standards in order to maintain their position on the market, improve their public relations and deliver superior-quality services. The pressure to achieve some ethical standards is also the result of certain public scandals with significant impact on the finance/advisory area (i.e.: Enron case, EY – Wirecard scandal).

Key words: code of ethics, standards of professional conduct, ethical principles, threats to ethical principles

Introduction

This subject was chosen as a result of its increasing importance in the finance area. More and more companies need to adopt certain codes of ethics in order to ensure a proper business environment. This is especially true for companies acting in the accountancy, advisory, audit and investment areas. The last decades have shown an important increase in the number of scandals within the accounting profession (Kiradoo, 2020), scandals which might have been avoided if proper ethical standards were encouraged and enforced starting with the top management of international accounting companies.

The primary question addressed by this paper is: what is the importance of professional ethics in the finance area for avoiding scandals and ethical dilemmas?

First, we have to define the ethics in finance. The UK-based Association of Chartered Certified Accountants defined ethics as a branch of philosophy that studies the difference between right and wrong . The US-based CFA Institute considers that ethics […] are essential to achieving its mission to lead the investment profession globally by promoting […], education, and professional excellence for the ultimate benefit of society.

Second, we must understand the importance of ethics in the finance field as well as to understand the necessity to include the code of ethics in any type of financial education. Bafghi considers that the basis of the accounting profession is based on ethics. McNair and Milam emphasize that developments in the business world have caused the academic community to address the coverage of ethics in the accounting curriculum. As shown by their 1993 study a significant majority of the accounting universities professors considered that while they covered the ethics part in their courses, more emphasis should be put on this matter. A more recent study conducted by Limijaya (2019) in this matter shows that three areas are capable of enhancing the learning of ethics in the accounting profession: emphasis on principles-based approach (instead of regulatory), shifting the focus on ethics education to avoid failures, generally adopt a role of business ethics.

Not in the last turn, the ethical standards also impact the way in which various professionals promote their services. State, Tanase and Petre (2019) conclude that professional ethics and deontology have a significant impact on the promotion of accounting services by professionals .

The research methodology used in this paper is based on qualitative method and includes the systematic review of applicable literature (books and papers published in scientific journals).

The next two sections cover the theoretical and practical concepts related to ethics in accountancy and external financial audit as well as the ethics in the investment area.

Ethics in accountancy and audit

1. General concepts

The accounting profession is distinguished from other professions through assuming responsibility in front of the public and all interested parties.

While members of the accounting profession have the duty to serve the public interest, the professional accounting bodies have a significant role in ensuring education, ethics, and quality within the accounting area. According to CECCAR's code of ethics, the regulation of the accounting profession is thought to ensure the protection of the public interest which is one of the ultimate roles of the professional accountant . Dixon (2018) shows that the training of professional accountants can build upon work done by the leaders of the accounting profession.

For example, a professional accountant might work for a company whose management requires him to book fraudulent transactions which ultimately lead to the manipulation of the financial statements of that company which in turn might induce the users of the financial statements into making wrong investment decisions. Normally, a professional accountant would not accept the booking of such transactions and might even report this manipulation to the external interested parties (i.e.: professional body of accountants, authorities).

In Romania, the body regulating the accountancy profession is CECCAR (The body of expert accountants and certified accountants from Romania), while the bodies regulating the auditor's profession are ASPAAS (The Authority for the Public Supervision of the Statutory Audit Activity) and CAFR (Chamber of Financial Auditors of Romania).

IFAC (International Federation of Accountants) is the parent organization of IESBA (International Ethics Standards Board for Accountants) which is responsible with the regulation of ethics applicable to the accounting profession at international level.

IESBA adopted several fundamental ethical principles which are also applicable in Romania via CECCAR/ASPAAS/CAFR. These principals are presented in the Revised Code of Ethics:

1. integrity – refers to the honesty of a professional accountant

2. objectivity – refers to the fact that a professional account should avoid conflicts of interest and not allow bias in their judgement and influence of other third parties

3. professional competence and due care – refer to the fact that a professional accountant should act in line with the applicable technical standards when providing services to clients / organizations and continue his professional development in order to maintain an adequate knowledge of law and techniques required to deliver adequate quality services

4. confidentiality – refers to the fact that a professional accountant should preserve the confidentiality of information gathered through business relations except for the situations exempted by law or when the accountant has the permission of the client / organization

5. professional conduct – refers to the fact that a professional accountant should not discredit the accounting profession and comply with the applicable laws and regulations

The main threats identified by ACCA within the Guidance on ethical matters for members in business that could impair the ethical principles mentioned above are:

1. self-interest – occurs when a member of the profession or one of his immediate relatives have certain financial or non-financial interests which might impair their objectivity and independence

2. self-review – occurs when a professional accountant has to review a work in which he had prior involvement

3. advocacy – occurs when a professional accountant supports a position that may ultimately impair his objectivity

4. familiarity – occurs when a member of the accounting profession develops close relationships with others within the business area

5. intimidation – occurs when a member is threatened either directly or as perceived

Next, several study cases illustrating the applicability of some of the threats to ethical principles will be presented.

2. Study case 1 – self-interest threat

Michael Smith has been working at an audit and advisory company for the last 5 years. Starting with 2020, he is the manager of the team involved in the audit of ABC Software Consulting's ("ABC") financial statements prepared in accordance with the International Financial Reporting

Standards for the year 2020. ABC Software Consulting is a company developing e-learning platforms for adults in UK and is listed on London Stock Exchange so its shares are publicly traded. Michael Smith also has a portfolio of equity and debt securities. Given that the IT sector had a better than average performance during the Covid-19 pandemic, Michael bought in 2020 a significant number of shares traded by ABC. Consequently, the ABC shares accounted for more than 50% of Michael's portfolio. Michael did not inform his employers about this acquisition.

After performing the audit mission, Michael is reviewing the work of his team and he founds one major issue with potential impact on the auditor's report. The Company capitalized research & development expenses in total amount of 81 million pounds on 31 December 2020 for a project that was considered a failure and cancelled in 2021 due to subsequent market changes and before the issuance of the 2020 financial statements; in other words, the intangible assets should be adjusted for impairment. The management's main arguments for not booking an impairment adjustment are:

• the event leading to the impairment of the R&D expenses took place after the year-end

• the management does not want to significantly impact the financial performance presented in the financial statements and desires to write off the intangible over a period of three years instead of one year because recognizing a loss directly in 2020 will lead to negative results presented in the income statement which would lead to the decrease of price per Company's share on London Stock Exchange.

For audit clients with similar problems, Michael issued qualified audit reports. Nevertheless, due to his financial interest in the Company and due to his fear that he might incur significant losses in his own portfolio of securities, he chooses not to include any mention in the auditor's report regarding the impaired R&D expenses. Soon after the issuance of the audit report, there appears to be a public coverage in the press regarding the project developed by ABC (for which the R&D expenses were recognized) and its failure. Given such news, the price of the shares of ABC drops and Michael comes under scrutiny from his employer due to his failure to report the impaired R&D expenses.

This is a classic case in which the self-interest threatens the ethical principles of a professional accountant/auditor.

3. Study case 2 – self-review threat

Patton & Partners is a multinational group providing financial services to various clients from various industries. The Company has separate legal entities for the following services: accounting, audit, fiscal advisory, transaction services, valuation services, payroll services, AOS, legal advisory. Until the end of 2020, Patton & Partners has been providing accounting services to EVE Logistics, a Dutch transportation company. Starting with 1 January 2021, the management of Patton decided to internalize the accounting function given the increase in the company's activity. Taking into account the good relationship with Patton & Partners accounting entity, the management of EVE decides to request auditing services for the year ended on 31 December 2020 from the same group. Due to an error occurring during the acceptance procedures, the management of the audit legal entity of Patton group does not realize that the accounting records for 2020 were kept by the same Group.

During the audit mission, the allocated team discovers several significant errors with impact on the auditor's report. When the audit partner reviews the file, he discovers the acceptance error and finds out that Patton also provided accounting services for the year ended on 31 December 2020. In other words, one legal entity of Patton Group kept the accounting records for 2020, while another audited those records and found several significant errors. Given that the audit partner did not want to discredit the accounting division of the Group, he chose not to report any significant findings in the audit report. This is the self-review threat.

Ethics in Investment Profession

1. General concepts

Given that the most developed market for investment profession is the United States market, the analysis of ethics from an investment professional's point of view will be made in regard to one of the most prestigious institute in the US Investment profession, namely the CFA institute. The CFA institute adopted a code of ethics which provide quite similar insights to the IESBA code of ethics (CFA Institute, Code of ethics and standard of professional conduct):

1. act with integrity, competence, diligence

2. place the integrity of the investment profession and clients' interests above personal interests

3. use reasonable care and exercise independent professional judgement

4. promote the integrity and viability of the capital markets

5. maintain and improve the professional competence

6. practice in an ethical manner

The CFA Institute also adopted a series of standards of professional conduct divided in several categories:

I. Professionalism

a. knowledge of the law – CFA members and candidates have to adhere to the strictest law (i.e.: in case the CFA standards are tougher than the local law, the member of candidate must adhere to the CFA code)

b. independence and objectivity – CFA members have to use reasonable care to avoid situations in which their independence is impaired (i.e.: gifts)

c. misrepresentation – members must not knowingly misrepresent their profession (i.e.: during investment advice)

d. misconduct – members must not be involved in fraud, deceit or similar actions

II. Integrity of capital markets

a. material non-public information – members who have such information must not act on it in order to affect the value of securities traded

b. market manipulation – members must not take actions as to mislead market participants in certain actions on the market (i.e.: through artificially inflating or deflating trade of a certain security in order to increase or decrease its price)

III. Duties to clients

a. loyalty, prudence and care – client's interests must be placed above personal interests

b. fair dealing – members must deal fairly with all their clients, not only with a certain group

c. suitability – members must understand the investment objectives of their clients, their risk aversion and their financial situation and act accordingly to such variables normally stated in an investment policy statement

d. performance presentation – for example, when a member communicates information related to the investment performance of a client's portfolio, he must make reasonable efforts that the client understands what he meant

e. confidentiality – confidentiality of information received from the client must be preserved except for cases in which disclosures are necessary according to law or when the client gives his consent

IV. Duties to employers

a. loyalty – members must act in the interest of their employer

b. additional compensation arrangements – members must disclose to their employers any compensations arising from other activities (especially those posing potential competition to the employers)

c. responsibilities of supervisors – supervisors must see that their personnel comply with the law / regulations and to ensure that adequate quality work in performed under their supervision

V. Investment analysis, recommendations, and actions

a. diligence and reasonable basis – members must have adequate basis for their investment recommendations

b. communication with clients and prospective – when communication with clients, members must not be deceptive in any way

c. record retention – members must preserve evidence of their recommendations and communications with clients and potential clients

VI. Conflicts of interest

a. disclosure of conflicts of interest – any conflict of interest must be disclosed to the employer and the clients when applicable

b. priority of transactions – clients have priority in face of members when it comes to trading in case a member is a beneficial owner of the potentially traded security

c. referral fees – any referral fees must be disclosed to clients and employers when conducting business transactions in the investment area

VII. Responsibilities of a member or candidate

a. conduct as participants in CFA program

b. reference to CFA institute, designation and program

Such standards are considered to improve the quality of services provided by professionals in the investment area, especially after the 2007-2008 financial crisis.

2. Study case

George Smith, CFA, is a Chief Investment Officer at Alpha, an investment adviser large pension clients. The compliance manual of Alpha is consistent with the CFA Standards. George also serves in his spare time as a member of board of directors for several entities. Some of those entities have their investments managed by Alpha.

One of Michael's duties is to supervise the research analysts and portfolio managers of Alpha. One of the portfolio managers, Steve David is also a shareholder of an IT company that develops and sells portfolio administration platforms to medium corporate clients. Some of those clients are also clients of Alpha where Steve works as a portfolio manager. During his work at Alpha, Steve made contacts with those clients and recommended them to buy software from his IT company. Steva disclosed his interest in the IT company to Alpha's management, his additional compensation and the possible conflicts of interest. Nevertheless, no such disclosures were made to his clients at Alpha.

According to standard VIa mentioned above, due to the fact that Steve is a portfolio manager with fiduciary responsibility for clients of Alpha who may also be clients of the IT company where Steve is a shareholder, this might compromise his ability to make unbiased and objective investment recommendations. Taking this into consideration, the potential conflict of interests should be disclosed not only to Alpha, but also to his clients.

Conclusions

This paper concludes that professional ethical values are highly important for counteracting issues in accounting that can discredit the reputation and of the accounting profession. As shown by the available literature, adhering to good ethical standards might help companies working in the financial areas avoid any public scandals which might completely damage their reputation and even cause their insolvency as was the case with Arthur Andersen in the Enron case.

Implementing the ethical standards as principles-based approach will lead to better financial reporting processes, more confidence in the markets and better representation of the public interest.

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