



**The Institute of  
Chartered Accountants  
in Australia**

## **INDEPENDENCE OF AUSTRALIAN COMPANY AUDITORS**

A paper by The Institute of Chartered Accountants in Australia (the ICAA) submitted to the Hon Ian Campbell, Parliamentary Secretary to the Treasurer, in response to the report *“Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform”* by Professor Ian Ramsay issued in October 2001.

### **Contents**

1. Introduction
2. General Comments
3. Progress in Australian Professional Independence Standards
4. Specific Comments
5. Auditor Independence Supervisory Board (AISB)

### **Appendices**

1. Re-Exposure Draft Professional Statement F.1 ‘Professional Independence’, issued December 2001, applicable to all members
2. Comparison of registration/regulation and oversight arrangements

## **1. INTRODUCTION**

The ICAA welcomes the opportunity to comment on Professor Ramsay's Report and to contribute to the debate on the important issue of auditor independence.

We look forward to continuing the consultation process initiated by Professor Ramsay and to working with government to ensure that the implementation of the recommendations is in line with international best practice. This paper is submitted to further progress this work with the overriding aim of ensuring the continuing application of the highest standards of the profession and the maximum possible consistency for the benefit of companies, shareholders, and all other stakeholders.

## **2. GENERAL COMMENTS**

Auditor independence is only one of a number of factors that contribute to well informed capital markets and while enquiries into recent corporate failures are ongoing we cannot yet know their conclusions. The adoption of the Professional Independence Exposure Draft (ED), which is expected by June 2002 doesn't conclude the task. The ICAA will continue its commitment to continuously review the professional ethical pronouncements to address issues that may arise, and to continue to explore other ways to enhance and keep pace with changes in the business environment.

Because of the importance of Independence to all members of the profession and to the audit process, our members were consulted for their views on the Ramsay recommendations. In particular, all members who have any relationship with the audit process (including audit practitioners, as well as those members who act as company directors and who prepare financial statements) were asked to consider the recommendations to enhance auditor independence.

This consultation process included:

- Member feedback questionnaire
- Focus groups
- Member submissions
- Feedback from representative groups such as Public Practice Advisory Committee, Accounting and Audit Discussion Group and Regional Councils.

Members supported the thrust of the Ramsay recommendations, with the exception of the establishment of the AISB. Whilst acknowledging the appropriateness of an oversight role there were concerns relating to duplication of the profession's processes and the necessity for such an oversight role to encompass broader issues, without limitation to "Independence" issues alone.

However the continuation of the co-regulatory regime between the accounting profession and regulators is viewed as a positive recommendation and ensures the on-going globalisation of independence rules. The ability to enhance the profession's ethical pronouncements in the future to address issues that may arise from the HIH Royal Commission was also seen as an opportunity for the Australian profession to take a leadership role, rather than the necessarily prescriptive approach created should a purely legislative environment prevail.

Also whilst recognising the need to update the existing provisions of the Corporations Act the ICAA notes that the accounting bodies' ethical pronouncements (in particular those addressing employment and family relationships) in their revised statement overlap and appropriately extend the recommended Corporations Act amendments.

Professor Ramsay's recommendation for the mandating of audit committees reinforces the shared responsibility of the auditor and its clients to ensure independence for the auditor. The ICAA strongly supports the need for mandatory independent audit committees for listed companies. As well as a core element of the Ramsay Report, it was also a key recommendation of the 1997 Government Report on "Registration and Regulation of auditors" as well as the accounting bodies' earlier 'Expectation Gap' Reports in 1993 and 1996.

Another of the key issues raised by Professor Ramsay is whether audit firms can continue to offer non-audit services to clients without compromising auditor independence. Significantly, research both here and overseas has found no evidence to support the suggestion that, after exclusion of those services which by their nature give rise to self-review risks, audit firms should not provide non-audit services to their audit clients. Whilst recognising that the current revisions to the accounting bodies' ethical pronouncements address such risks, the accounting bodies recognise that we must continue to look carefully at any evidence that emerges from current enquiries where the quality of audit and independence of auditors might be improved.

We also recognise that we could benefit from a form of public oversight that considers the broad reach of both the issues and all the multitude bodies that impact on the accuracy of financial information and disclosures provided to capital markets and pertinent to investment decisions. Whilst the support of the ICAA for an oversight role continues we would welcome the opportunity to explore both existing, and alternative, external oversight structures for the auditing profession. Rather than establishing a wholly new board an existing entity, such as the Financial Reporting Council (FRC), could be a possibility albeit that some restructuring of that body would be required.

We, and we believe the profession in general, is of the view that reviewing Independence is but a small part of what is required from a much broader review. The review should encompass wider issues in relation to the capital markets including the audit report itself (content, timing and key risk management issues), accounting and auditing standards, general financial disclosing practices including the financial health of a company, limitation of liability, auditor training and research as well as corporate governance strategies that address the responsibilities and actions of directors, institutional shareholders and business analysts. We are very committed to provide leadership with the Government in such a review.

### **3. PROGRESS IN AUSTRALIAN PROFESSIONAL INDEPENDENCE STANDARDS**

Changes in the global economy, technology developments, and the expanding services performed by the accountancy profession are among the reasons why IFAC decided to update their independence rules and adopted changes to their Code of Ethics for Professional Accountants in November 2001. While, the Enron and HIH collapses have made the auditor's role an urgent consideration for the profession they occurred at the conclusion of an extensive review of auditor independence last year.

The Australian accounting bodies (ICAA and CPA Australia) have worked together to update their own existing statement by releasing in December 2001 their Professional Independence Exposure Draft (ED). The ED is based on the IFAC Code of Ethics for Professional Accountants but strengthens a number of the key guidelines even further, including:

- A mandatory two-year waiting period before a retired audit partner involved in the audit of a client can become a director of that client;
- Assurance fees from a single client not to exceed 15% of total fees, so as to avoid the perception that self-interest may impair audit independence. This trigger level does not exist in the IFAC standard where, instead, members are required to determine whether a 'substantial proportion' of their total fees come from a single client.

This extra clarity provides a yardstick for members.

Both organizations have called for feedback from members and interested stakeholders before the ED is formally adopted in their joint Code of Professional Conduct (CPC), which is expected by June 2002.

Accountants around the world recognize that independence, particularly in relation to audit, is a key concern to regulators and users of financial information because it is central to their ability to effectively contribute to protecting the public interest. The joint ED sets a new benchmark in international best practice on professional independence for the majority of auditors in Australia. They take into account the IFAC standard and impose stricter requirements for the Australian environment.

While it is impossible to establish rules that cover every scenario, this ED provides a framework of safeguards that can be applied by members of the profession to specific circumstances and relationships, and are complemented by the ongoing quality assurance program, safeguards within the firm's own systems and procedures and additional reviews individual members must undertake as part of their membership of their professional body.

This will provide members with greater clarity and certainty and will be binding on all members of the Australian accounting bodies.

The complete Independence Exposure Draft is attached as Appendix 1. However an outline of the process to be used by auditors to determine their Independence is based on the following three fundamental steps:

### 3.1 Identifying Threats

When determining audit independence the first step is to identify the threats to independence.

The threats to independence in assurance engagements are:

- *Self interest threat*: this is when a firm or a member of the assurance team could benefit from a financial interest in or other self interest conflict, with an assurance client. This could arise in superannuation funds where it is the members own fund or the member provides financial advice to the fund trustees.
- *Self review threat*: this is when:
  - (1) The product of another engagement needs to be re-evaluated in reaching conclusions on the assurance engagement i.e. the member is reviewing their own work; or
  - (2) Where a member of the assurance team was previously in a position to exert direct influence over the subject matter of the engagement.
- *Advocacy Threat*: this is when a firm or team member promotes an assurance clients position to the point objectivity is or is perceived to be compromised. This can arise where a firm promotes a particular tax / investment strategy which has not been reviewed for compliance by a third party.
- *Familiarity Threat* – this is when a close relationship with the assurance client and the firm or a member of the team becomes too sympathetic to the clients interests.
- *Intimidation Threat* – where a member of the team is deterred from acting objectively due to threats, actual or perceived, from an associate of an assurance client.

### 3.2 Identifying Safeguards

Once the threats have been identified the next step is to determine whether there are any safeguards, which will eliminate or reduce the threats.

There are three categories of safeguards:

- Those created by the profession, legislation or regulation;
- Those within the assurance client; or
- Those within the firms own systems and procedures.

### 3.3 Thence making an Objective Assessment

The third step is to look at the threats and safeguards objectively and determine whether the assurance engagement can be undertaken independently.

Members in public practice must both be and be seen to be free of any interest, which is incompatible with objectivity. The guidance supporting this indicates a ‘reasonable

person' test be applied i.e. what would a reasonable person having knowledge of the relevant facts and taking into account the member's behaviour determine is independent.

## **4. SPECIFIC COMMENTS**

### **Recommendation 5.04 - Corporations Act to include general statement of principle**

The ICAA supports recommendation 5.04

#### **Additional Comments**

Essential that such a general statement of principle is consistent in both the language and spirit with the requirements of the more extensive ethical pronouncements of the accounting bodies. The opportunity to include a conceptual framework to preserve auditor independence in our ethical pronouncements permits greater clarity and a fuller understanding than a legislative statement of principle.

Suggested Commentary to general statement of principle:

“The use of the word independence on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgement ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information, would reasonably conclude to be unacceptable.”

OR

By reference to ethical pronouncements of professional accounting bodies incorporated in general statement of principle.

### **Recommendation 5.05 - Annual declaration by auditor to the Board**

The ICAA supports recommendation 5.05.

#### **Additional Comments**

Further legislative or standards changes may be required to effect this recommendation in a seamless manner and to ensure that multiple declarations (e.g. ASIC, ASX, AISB) do not result.

## **Recommendation 5.28 - Continuation of co-regulation model**

The ICAA supports recommendation 5.28.

## **Recommendation 5.35 - Employment relationships:**

The ICAA supports recommendation 5.35.

### **Additional Comments**

While the ICAA acknowledges the appropriateness of updating the existing provisions of the Corporations Act, the accounting bodies' ethical pronouncements overlap and extend the recommended Corporations Act amendments.

The ICAA is concerned that the limitation on consulting arrangements with an officer or senior employee of the audit client for accounting or auditing matters should be extended to all such consultancy arrangements by deleting the words "on accounting or auditing matters" from recommendation 5.35(6).

## **Recommendation 5.59 - Financial relationships and business relationships**

The ICAA supports recommendation 5.59

### **Additional Comments**

While the ICAA acknowledges the appropriateness of updating the existing provisions of the Corporations Act, the accounting bodies' ethical pronouncements overlap and extend the recommended Corporations Act amendments.

Recommendation 5.59 is substantially in accordance with ethical pronouncements addressing financial interests in the revised statement (as based on IFAC requirements), in particular paragraphs 2.3 to 2.25 dealing with financial relationships and paragraph 2.31 dealing with close business relationships. Note: revisions to IFAC requirements subsequent to the publication of the Ramsay Report necessitate a review of recommended wording as it relates to "other client service personnel".

## **Recommendation 5.94 - Provision of non-audit services and 6.75ff – Audit Committee**

The ICAA supports recommendations 5.94 (a), (b), (c) and 6.75.

### **Additional Comments**

Recommendation (a) has been progressed by the accounting bodies with the issuing of a revised statement, based on the IFAC Code of Ethics for Professional Accountants. The accounting bodies have called for feedback from members and interested stakeholders before the ED is formally adopted in their joint Code of Professional Conduct (CPC).

Once adopted the revised statement will provide members with greater clarity and certainty and will be binding on all members of the Australian accounting bodies.

Recommendation (b) for mandatory disclosure of non-audit services extends the existing disclosure requirements of the Accounting Standards. While it is supported by the accounting bodies we note that the disclosure requirements in financial statements are an Australian Accounting Standards Board matter and beyond the control of the professional accounting bodies.

Recommendation (c) for a mandatory independent Audit Committee for listed companies is seen as a significant reform that will enhance the public's perception of audit independence. This was first proposed by the Australian Accounting Profession in its Expectation Gap Reports in 1993 and 1996, and supported by a Government Working Party in 1997. The responsibilities of an Independent Audit Committee are outlined in greater detail in *The Audit Committees Best Practice Guide*. The accounting bodies confirm their support for the mandating of audit committees to reinforce shared responsibility to ensure both the independence, and the perception of independence, for the auditor.

Refer to section 5 for further discussion of AISB proposal addressed in recommendation (d).

## **Recommendation 6.105 – Appointment and Removal of Auditors**

### **Response**

The ICAA supports recommendation 6.105.

### **Additional Comments**

Recommendation (c) is seen as an aid to the perception of independence and has been progressed by the accounting bodies with the issuing of a revised statement based on the IFAC Code of Ethics for Professional Accountants. We note that the IFAC Code and thus the revised statement reflect the necessity to acknowledge that there are limited circumstances where rotation may not be an appropriate safeguard and other safeguards such as involving an additional professional accountant to review the work done or otherwise advise as necessary.

While recommendations (a), (b), (d) and (e) are supported by the accounting bodies we note that these recommendations are beyond the control of the professional accounting bodies.

## **Recommendation 6.122 – Disciplinary matter**

The ICAA supports recommendation 6.122.

### **Additional Comments**

Rather than a hierarchy of membership of the Companies Auditors and Liquidators Disciplinary Board (CALDB) (i.e. members, deputy members and reserve members) it would appear to be simpler to expand the number of full members of the Board from which a panel can be selected to hear particular cases, taking into account any potential conflicts and the need for particular expertise.

## **Recommendation 6.127 – Attendance of Auditor at AGM**

The ICAA supports recommendation 6.127

### **Additional Comments**

Further guidance relating to the role of the auditor when attending the AGM will be required.

## **Recommendation 7.22 – Other Issues Considered during Review**

The recommendations are duplicated here as they are not readily summarized into a descriptive heading.

### *7.22*

1. *Educational requirements for registration as a company auditor should be enhanced by requiring all applicants to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year Program [now CA Program] or CPA Australia's Certified Practising Accountant Program.*
  
2. *All registered company auditors, whether members of professional accounting bodies or not, should be required to abide by ethical requirements equivalent to the codes of ethics and other rules of the professional accounting bodies. This can be achieved by those registered company auditors who are not members of professional accounting bodies complying with rules or guidelines issued by ASIC or entering into a written undertaking with ASIC that they will comply with the ethical requirements and other professional rules of the professional accounting bodies as if they were members.*

- 3 *Competency standards should be adopted as the principal basis for determining whether a person has sufficient practical experience to be registered as a company auditor.*
- 4 *Where a registered company auditor has not undertaken any substantive audit work during a period of not less than five years, ASIC may require the auditor to show cause why his or her registration should not be cancelled.*
- 5 *The requirement that registered company auditors lodge a triennial statement with ASIC should be replaced by an annual statement containing the revised information outlined in paragraph 7.13 of this report.*
- 6 *Registered company auditors should be required to undertake a minimum amount of professional development, with the amount to be prescribed being similar to that required of ICAA and CPA Australia members who hold public practice certificates.*
- 7 *The work of all registered company auditors should be subject to periodic quality reviews.*
- 8 *The Corporations Act should be amended to provide that Auditors-General may, subject to any constraints contained in the legislation establishing their respective offices, delegate to a person responsibility for signing an auditor's report or an audit review prepared under Part 2M.3 of the Corporations Act.*

The ICAA continues to support the introduction of an audit competency model for registered company auditors (RCAs) and acknowledges the support provided by Professor Ramsay.

## **Additional Comments**

The above recommendations are considered essential to ensure that all registered company auditors, whether or not members of a professional accounting body that conducts a quality review program, are required to abide by the best practice expected of the Australian accounting profession.

## **5 AISB PROPOSAL**

While the ICAA acknowledges the inter-relationships of the Ramsay recommendations they remain unconvinced that the structure of the AISB is the best way to proceed. A similar body (the Independence Standards Board) in the US was abolished last year. However it is interesting to see that the US Securities and Exchange Commission has recently called for a Public Oversight Board which may adopt other processes that already exist in Australia with an external oversight of auditors (eg CALDB).

As an International Federation of Accountants (IFAC) member and supporter of international harmonization the ICAA continues to monitor such developments overseas. Also essential in a global environment is the need to be conscious that differing frameworks, both structural and regulatory, exist, as well as significant differences in their operational aspects. For example, the US Government has almost no formal role in monitoring how accounting firms conduct their audits of listed companies, which contrasts with ASIC's role in referring matters concerning RCAs to the CALDB.

Of concern is the proposed role of the AISB (paragraph 4.4) in monitoring the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and the possible duplication with some of the functions carried out by the accounting bodies, in particular our established quality review programs. Unlike the US this is not a firm-on-firm review.

In order to avoid any duplication, we recommend that the accounting bodies' existing quality review requirements be adopted.

The accounting bodies have established quality review programs for all members holding a Certificate of Public Practice. All registered company auditors, who are members of the accounting bodies, are required to hold a Certificate of Public Practice and subject to a review once every 5 years. APS 4: Statement of Quality Control Standard defines quality control as the "policies and procedures adopted by a practice designed to maintain adherence to professional standards". These professional standards include independence.

During a quality review, practices are asked to respond to a series of questions in relation to independence issues. The responses are discussed by the practice with their reviewer. If required, the practice is requested to address any issue(s) raised. The questions are based on the current audit independence requirements as prescribed by the Corporations Act 2001, ethical statements, etc. The effectiveness of the Quality Review program in monitoring audit independence would be enhanced by the introduction of the changes proposed by Ramsay and supported by the accounting bodies in Section 3. The questions are reviewed on a regular basis and amended as and when required. The Quality Review questions would be reviewed and amended to reflect these changes.

Paragraph 4.7 on page 14 of the report states that it is not appropriate for the AISB to conduct disciplinary proceedings given that disciplinary mechanisms are already in existence and paragraph 3.1 on page 13 of the report acknowledges that funding for the AISB should not be a drain on scarce public resources. Accordingly, in our opinion the accounting bodies perform the monitoring of audit firms, as outlined in paragraph 4.4, as part of the quality review program.

Paragraph 7 on page 18 of the report recommends that the work of all registered company auditors should be subject to periodic quality reviews.

The oversight role should be clearly defined as supervisory and complementary to these processes rather than a duplication. Consideration also needs to be given to monitoring the adequacy of non-audit service fee disclosures and monitoring the effectiveness of listed company audit committees, particularly in relation to whether

these recommendations are adopted as amendments to the Listing Rules or Corporations Act.

Given that the purpose of the proposals is to provide greater integrity to the financial markets the financial burden of such a board on a relatively small number of practitioners or the accounting bodies is considered inappropriate.

# COMPARISON OF REGISTRATION/REGULATION AND OVERSIGHT ARRANGEMENTS FOR COMPANY AUDITORS

A BRIEF SUMMARY OF THE REGIMES FOR COMPANY AUDITORS IN THE US, UK AND AUSTRALIA FOLLOW:

## 1. Registration

### USA

CPAs are registered with State Board of Accountancy to practice (including as auditor) and are then eligible to join State CPA Society and/or AICPA.

### UK

Each of the major accountancy bodies is a “recognised supervisory body” for the purposes of company auditing and issue licences to firms to practice as auditors.

### Australia

ASIC is the registration body for company auditors. Requirements for registration are:

- Member of ICAA or CPAA, or
- Prescribed tertiary qualifications, or
- Other qualifications and experience equivalent to either of above and, prescribed practical experience in auditing, assessed as being capable of performing the duties of an auditor, and is a fit and proper person.

## 2. Regulation/Discipline

### USA

AICPA and State Societies may take disciplinary action against members and exclude them from membership. However, they cannot revoke a licence to practice as a CPA, which is the province of the State Boards of Accountancy

In an announcement in January 2002, the SEC Chairman foreshadowed the establishment of a new body that would have responsibility for discipline and quality control of those individuals and firms that audit “public companies”. Violations of the law would be handled by the SEC with violations of ethical and/or competence standards to be handled by the new body, which would have the power to restrict individuals and firms from auditing public companies. It is also intended that this body reform the current peer review process to avoid firm-on-firm reviews.

## **UK**

Under the new system of regulation of the accountancy profession in the UK, the Joint Disciplinary Scheme (operated by the ICAEW and ICAS to deal with major audit failures involving their members) has been replaced by a Investigation & Discipline Board (IDB) which will focus on “matters of public concern” involving members of all the UK bodies. The investigation and discipline of other matters will continue to be dealt with by the individual bodies. The normal channel of reference to the IDB will be from the individual bodies though the IDB will have power to “call in” cases after consultation with the body concerned. The IDB is funded by the profession.

## **Australia**

Under the Corporations Law the ASIC may refer matters concerning the performance of a registered company auditor to the Companies Auditors & Liquidators Disciplinary Board (CALDB), which has the power to cancel or suspend registration or impose a number of other sanctions.

The Institute may take disciplinary action against members, including for breaches of ethical requirements (e.g. independence) but has no jurisdiction over a member’s registration as a company auditor. However, the fact that a member has been sanctioned by the CALDB is grounds for disciplinary action by the Institute.

### **3. “Oversight” bodies**

## **USA**

The Public Oversight Board oversees the AICPA’s SEC Practice Section (SECPS), the Auditing Standards Board and, until it was disbanded in July 2001, the Independence Standards Board. All AICPA members engaged in the audit of companies that file with the SEC are required to join the SECPS and their dues fund the POB. The SECPS currently requires its member firms to undergo a peer review every three years. It is not clear from the statement by the SEC Chairman referred to above what ongoing role the POB will have, however a proposal for funding by the profession is clearly viewed by the board members as compromising their independence.

**Note:** The president’s 10-Point Plan (7 March 2002) clearly intends that the SEC will have supervision of and “independent” regulatory board, in addition to establishing guidelines for NAS and oversight of the Financial Standards Board.

## **UK**

A Review Board (also funded by the profession) will oversee the operations of the IDB, the Auditing Standards Board and a newly formed Ethics Standards Board. It will also monitor the continuing responsibilities of the bodies for (inter alia) qualification and registration of accountants and auditors, handling of complaints and the conduct of investigation and discipline cases falling outside the remit of the IDB.

## **Australia**

Ramsay proposal is for an Audit Independence Supervisory Board funded, but not controlled by the profession. The main functions of the AISB would be to:

- Monitor international developments in auditor independence

- Advise professional bodies on issues of auditor independence
- Monitor audit firms
- Monitor corporations
- Monitor the teaching of professional and business ethics

It would have no role in conducting disciplinary proceedings but would monitor adequacy of existing processes.



The Institute of  
Chartered Accountants  
in Australia

Issued for comment by The  
Institute of Chartered  
Accountants in Australia and  
CPA Australia



Re-exposure Draft  
December 2001

# PROFESSIONAL STATEMENT F.1

*Applicable to all members*

## Professional Independence

### CONTENTS

	<b>Paragrap h(s)</b>
Scope of Guidance	1 - 8
Principles	9 - 13
Definitions	14- 15
<i>Assurance engagements</i>	16
Appointments Generally	17
Personal and Business Relationships	18
Conflicts	19 - 24
Commission	25
Fees	26
Goods and Services from Clients	27
Professional Help	28
Appendices	
1: <i>Independence for Assurance engagements</i>	1.1 – 1.43
2: Application of Principles to Specific Situations	2.1 – 2.112
3: Conformity with International Standards on <i>Independence for Assurance engagements</i>	3.1 – 3.2

## Scope of Guidance

1. Members should be guided, not merely by the terms, but also by the spirit of this Statement. Members should be prepared to justify to The Institute of Chartered Accountants in Australia (the Institute)/CPA Australia, if called upon, any apparent transgression from all the provisions and spirit of this Statement.
2. This Statement is confined to the professional aspect of *independence* as distinct from any requirements which may be imposed by law. Members should also ensure they comply with the spirit and the letter of the law.
3. Members practising overseas are required to comply with this Statement or the local ethical guidelines if they are stricter.
4. The requirements within this Statement apply to the extent that they do not conflict with legislation relating to a statutory appointment of Auditors General.
5. The fact that a member is performing an assignment in a voluntary capacity should in no way compromise the standards required by this Statement.
6. This Statement is applicable to all members. Appendices 1 and 2 apply specifically to *assurance engagements* and extend the requirements of this Statement to those engagements.
7. Particular requirements apply to insolvency appointments and members are referred to Statement of Professional Practice APS 7.
8. The provisions of this Statement applicable in the case of a company apply in the case of other enterprises. For this purpose, “other enterprise” means any business organisation, incorporated or otherwise, other than a company and includes a partnership or trust.

## Principles

9. Professional *independence* is a concept fundamental to the accounting profession requiring a member to approach their professional work with integrity and objectivity.
10. In each professional assignment undertaken, a member in public practice must both be and be seen to be free of any interest which is incompatible with objectivity. This is self evident in the exercise of the reporting function but also applies to all other professional work. In determining whether a member in public practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of the relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself or herself in a position where his or her objectivity would or could be impaired.
11. A member not in public practice has a duty to be objective in carrying out his or her professional work whether or not the appearance of professional *independence* is attainable. Thus a member performing professional work in commerce, industry or the public service must recognise the problems created by personal relationships or financial involvements which by reason of their nature or degree might threaten his or her objectivity.

12. The use of the word *independence* on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude to be unacceptable.
13. Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to *independence* and specify the appropriate mitigating action that should be taken.

## Definitions

14. The following expressions, when used in this Statement, have the meanings assigned to them in this paragraph:

<i>Audit client</i>	An entity in respect of which a <i>firm</i> conducts an <i>audit engagement</i> . When the <i>audit client</i> is a <i>listed entity</i> , <i>audit client</i> will always include its related entities.
<i>Audit engagement</i>	An <i>assurance engagement</i> to provide a high level of assurance that financial reports are free of material misstatement, such as an engagement in accordance with Australian Auditing Standards. This includes a statutory audit which is an audit required by legislation or other regulation.
<i>Assurance client</i>	An entity in respect of which a <i>firm</i> conducts an <i>assurance engagement</i> .
<i>Assurance engagement</i>	An engagement conducted to provide: <ol style="list-style-type: none"> <li>(a) a high level of assurance that the subject matter conforms in all material respects with identified suitable criteria; or</li> <li>(b) a moderate level of assurance that the subject matter is plausible in the circumstances.</li> </ol> <p>This would include an engagement in accordance with the Australian Auditing Standard AUS 108 “Assurance Engagements” issued by the Australian Auditing &amp; Assurance Standards Board (AAU&amp;ASB) or in accordance with specific standards for <i>assurance engagements</i> issued by the AAU&amp;ASB such as an audit or review of financial reports in accordance with Australian Auditing Standards.</p>
<i>Assurance team</i>	<ol style="list-style-type: none"> <li>(a) All professionals participating in the <i>assurance engagement</i>;</li> <li>(b) All others within a <i>firm</i> who can directly influence the outcome of the <i>assurance engagement</i>, including:             <ul style="list-style-type: none"> <li>• those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the <i>assurance engagement</i> partner in connection with the performance of the <i>assurance engagement</i>. For the purposes of an <i>audit engagement</i> this includes those at all successively senior levels above the <i>lead engagement partner</i> through the <i>firm’s</i> chief executive;</li> </ul> </li> </ol>

- those who provide consultation regarding technical or industry specific issues, transactions or events for the *assurance engagement*; and
- those who provide quality control for the *assurance engagement*.

and

- (c) For the purposes of an *audit client*, all those within a *network firm* who can directly influence the outcome of the *audit engagement*.

<i>Close family</i>	A parent, non-dependent child or sibling.
<i>Direct financial interest</i>	<p>A <i>financial interest</i>:</p> <ul style="list-style-type: none"> <li>• owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or</li> <li>• beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has control.</li> </ul>
<i>Directors and officers</i>	Those charged with the governance of an entity, regardless of their title.
<i>Financial interest</i>	An interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
<i>Firm</i>	<p>(a) A sole practitioner, partnership or corporation of professional accountants;</p> <p>(b) An entity that controls such parties; and</p> <p>(c) An entity controlled by such parties.</p>
<i>Immediate family</i>	A spouse (or equivalent) or dependent.
<i>Independence</i>	<p><i>Independence</i> is:</p> <p>(a) <i>Independence</i> of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and</p> <p>(b) <i>Independence</i> in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a <i>firm's</i>, or a member of the <i>firm's</i>, integrity, objectivity or professional scepticism had been compromised.</p>
<i>Indirect financial interest</i>	A <i>financial interest</i> beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.
<i>Lead engagement partner</i>	In connection with an audit, the partner responsible for signing the report on the consolidated financial reports of the <i>audit client</i> , and, where relevant, the partner responsible for signing the report in respect of any entity whose financial reports form part of the consolidated financial reports and on which a separate stand-alone report is issued. When no consolidated financial reports are prepared, the <i>lead</i>

*engagement partner* would be the partner responsible for signing the report on the financial reports.

<i>Listed entity</i>	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
<i>Network firm</i>	An entity under common control, ownership or management with the <i>firm</i> or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.
<i>Office</i>	A distinct sub-group, whether organized on geographical or practice lines.
<i>Related entity</i>	An entity that has any of the following relationships with the client: (a) An entity that has direct or indirect control over the client provided the client is material to such entity; (b) An entity with a <i>direct financial interest</i> in the client provided that such entity has significant influence over the client and the interest in the client is material to such entity; (c) An entity over which the client has direct or indirect control; (d) An entity in which the client, or an entity related to the client under (c) above, has a <i>direct financial interest</i> that gives it significant influence over such entity and the interest is material to the client and its <i>related entity</i> in (c); (e) An entity which is under common control with the client (hereinafter a "sister entity") provided the sister entity and the client are both material to the entity that controls both the client and sister entity; and (f) As defined by applicable legislation.

15. It is not possible to give a definition of "material" which would cover all circumstances where materiality is referred to herein. In such circumstances regard will be had to the effect which an interest might have or be seen to have on the objectivity of a person in a firm.

### ***Assurance engagements***

16. Appendix 1 to this Statement provides a framework, built on principles, for identifying, evaluating and responding to threats to *independence*. The framework establishes principles that members of *assurance teams, firms* and *network firms* should use to identify threats to *independence*, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. This Statement requires members of *assurance teams, firms* and *network firms* to apply the principles to the particular circumstances under consideration. The examples presented in Appendix 2 are intended to illustrate the application of the principles in this Statement and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to *independence*. Consequently, it is not sufficient for a member of an *assurance team, a firm* or a *network firm* merely to comply with the examples presented, rather they must apply the principles in this Statement to the particular circumstances they face.

### **Appointments Generally**

17. Whenever a *firm* or any person in a *firm* is asked to accept an appointment, consideration must be given to whether acceptance might give rise to a situation in which the professional *independence* of the *firm* or of the individual may be, or may appear to be, compromised. In the case of an existing appointment, should a situation arise in which professional *independence* is threatened, immediate steps must be taken to resolve the conflict.

## Personal and Business Relationships

18. Personal and business relationships can affect objectivity. There is a particular need, therefore, for a *firm* to ensure that its objective approach to any assignment is not endangered as a consequence of any such relationship. By way of example, objectivity may be impaired where a person in a *firm* has a mutual business interest with an *officer* or employee of a client or has an interest in a joint venture with a client.

## Conflicts

19. Conflicts of interest have an important bearing on actual and perceived *independence*. A *firm*, or *network firm*, should not accept or continue an engagement in which there is, or is likely to be, a significant conflict of interest between the *firm* and its client.
20. It is recognised that, from time to time, unavoidable conflicts of interest or of duty will occur. Conflicts are generally of two types:
  - there may be an actual or perceived conflict between the respective interests of two or more clients of a *firm*; or
  - there may be an actual or perceived conflict between the duty owed by the *firm* or a person in the *firm* to a client and the personal interest of the *firm* or a person in the *firm*.
21. In all cases, a *firm* and each partner shall ensure that a detailed explanation and disclosure of the conflict is made to the clients together with details of the safeguards referred to below, so they may make an informed decision as to whether to engage the *firm* or continue their relationship with the *firm*. Unless security considerations dictate otherwise it would be prudent for this to be in writing.
22. Where a *firm* becomes aware of a possible conflict between the interests of two or more clients, all reasonable steps should be taken to manage the conflict and thereby avoid any adverse consequences. These steps should include the following safeguards, except where they are inappropriate:
  - the use of different partners and teams of staff for different engagements;
  - standing instructions and all other steps necessary to prevent the leakage of confidential information between different teams and sections within the *firm*;
  - regular review of the situation by a partner not personally involved with those clients; and
  - advising at least one or all clients to seek additional independent advice.
23. Where there is a conflict of duty, such as where two clients are, or are about to become in dispute, or in competition otherwise than in the ordinary course of business (eg in a take over), the *firm* must not advise both clients on the matter, unless consent to do so is received from both clients. The *firm* may elect to continue to advise one client on the matter provided written consent has been obtained from both clients. In a dispute the *firm* may, if requested by both clients, act as mediator but not as arbitrator.
24. A *firm* shall not represent or continue to represent conflicting interests in potential or actual litigation (including divorce and partnership dissolution). A *firm* can only represent both parties in other matters where to do so is not likely to prejudice the interests of either party and where both parties are fully informed of the nature and implications and voluntarily assent in writing to the *firm* so acting or continuing to act.

## **Commission**

25. Acceptance of commission by a *firm* or by any person in a *firm* could impair the professional *independence* required of members. Members are referred to paragraph D.2 in the Code of Professional Conduct and paragraph 2.110 of this Statement which identifies that the receipt of commissions or other benefits as a result of the *assurance engagement* poses a risk to *independence* that cannot be resolved by safeguards other than the refusal to perform the engagement.

## **Fees**

26. When the receipt of recurring fees from a client or group of connected clients represents a large proportion of the total gross fees of a *firm*, the extent of dependence on that client or group of connected clients will inevitably come under scrutiny and raise doubts as to objectivity. It is not possible to give precise guidance on the proportion of fees which should not come from one client or a group of connected clients. However, if such fees are the only income or a substantial part of the gross income the *firm* should carefully consider its position.

## **Goods and Services from Clients**

27. No person in a *firm*, or *immediate family* of any person in the *firm*, shall accept from a client goods or services on terms more favourable than those generally available to others. Hospitality or gifts on a scale which is not commensurate with normal courtesies of social life must not be accepted.

## **Professional Help**

28. In cases where a member is concerned about *independence*, that member is invited to consult the Institute/CPA Australia who will use their best endeavours to provide a basis on which the member's concerns can be discussed, in confidence, with an experienced member or members. Confidentiality and objectivity are the essence of such discussions.

## Appendix 1

### ***Independence for Assurance engagements***

- 1.1 It is in the public interest and, therefore, required by the Institute's and CPA Australia's Code of Professional Conduct (CPC), that members of *assurance teams, firms* and, when applicable, *network firms* be independent of *assurance clients*.
- 1.2 *Assurance engagements* are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria. The Australian Auditing Standard AUS 108 "Assurance Engagements" issued by the AAU&ASB describes the objectives and elements of *assurance engagements* to provide either a high or a moderate level of assurance. The AAU&ASB has also issued specific standards for certain *assurance engagements*. For example, Australian Auditing Standards include specific standards for audit (high level assurance) and review (moderate level assurance) of financial reports.

Paragraphs 1.3 through 1.6 are taken from the Australian Auditing Standard on *Assurance engagements* and describe the nature of an *assurance engagement*. These paragraphs are presented here only to describe the nature of an *assurance engagement*. To obtain a full understanding of the objectives and elements of an *assurance engagement* it is necessary to refer to the full text contained in the International Standards on *Assurance engagements*.

- 1.3 Whether a particular engagement is an *assurance engagement* will depend upon whether it exhibits all the following elements:
- (a) a three party relationship involving:
    - (i) a professional accountant;
    - (ii) a responsible party; and
    - (iii) an intended user;
  - (b) a subject matter;
  - (c) suitable criteria;
  - (d) an engagement process; and
  - (e) a conclusion.

The responsible party and the intended user will often be from separate organisations but need not be. A responsible party and an intended user may both be within the same organisation. For example, a governing body may seek assurance about information provided by a component of that organisation. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement.

- 1.4 There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:
- engagements to report on a broad range of subject matters covering financial and non-financial information;
  - attest and direct reporting engagements;
  - engagements to report internally and externally; and
  - engagements in the private and public sector.
- 1.5 The subject matter of an *assurance engagement* may take many forms, such as the following:
- data (for example, historical or prospective financial information, statistical information, performance indicators);
  - systems and processes (for example, internal controls);
  - behaviour (for example, corporate governance, compliance with regulation, human resource practices).

- 1.6 Not all engagements performed by professional accountants are *assurance engagements*. Other engagements frequently performed by professional accountants that are not *assurance engagements* include:
- agreed-upon procedures;
  - compilation of financial or other information;
  - preparation of tax returns when no conclusion is expressed, and tax consulting;
  - management consulting; and
  - other advisory services.

## **A Conceptual Approach to *Independence***

- 1.7 *Independence* requires:
- (a) *Independence* of mind:  
The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- (b) *Independence* in appearance:  
The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a *firm's*, or a member of the *assurance team's*, integrity, objectivity or professional scepticism had been compromised.
- 1.8 The nature of *assurance engagements* may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires *firms* and members of *assurance teams* to identify, evaluate and address threats to *independence*, rather than merely comply with a set of specific rules, which may be arbitrary, is, therefore, in the public interest.
- 1.9 This appendix is based on a conceptual approach, one that takes into account threats to *independence*, accepted safeguards and the public interest. Under this approach, *firms* and members of *assurance teams* have an obligation to identify and evaluate circumstances and relationships that create threats to *independence* and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the *firm*, *network firms*, members of the *assurance team* and the *assurance client*, consideration should be given to whether relationships between individuals outside of the *assurance team* and the *assurance client* create threats to *independence*.
- 1.10 This appendix provides a framework of principles that members of *assurance teams*, *firms* and *network firms* should use to identify threats to *independence*, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that *independence* of mind and *independence* in appearance are not compromised.
- 1.11 The principles in this appendix apply to all *assurance engagements*. The nature of the threats to *independence* and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual engagement: whether the *assurance engagement* is an *audit engagement* or another type of engagement; and in the case of an *assurance engagement* that is not an *audit engagement*, the purpose, subject matter and intended users of the report. A *firm* should, therefore, evaluate the relevant circumstances, the nature of the *assurance engagement* and the threats to *independence* in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the *assurance team*.

- 1.12 *Audit engagements* provide assurance to a wide range of potential users; consequently, in addition to *independence* of mind, *independence* in appearance is of particular significance. Accordingly, for *audit clients*, the members of the *assurance team*, the *firm* and *network firms* are required to be independent of the *audit client*. Similar considerations in the case of *assurance engagements* provided to non-audit *assurance clients* require the members of the *assurance team* and the *firm* to be independent of the non-audit *assurance client*. In the case of these engagements, consideration should be given to any threats that the *firm* has reason to believe may be created by *network firm* interests and relationships.
- 1.13 In the case of an assurance report to a non-audit *assurance client* expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter and limitations of the report through their participation in establishing the nature and scope of the *firm's* instructions to deliver the services, including the criteria by which the subject matter are to be evaluated. This knowledge and enhanced ability of the *firm* to communicate about safeguards with all users of the report increase the effectiveness of safeguards to *independence* in appearance. These circumstances may be taken into account by the *firm* in evaluating the threats to *independence* and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it will be necessary to apply the provisions of this appendix in evaluating the *independence* of members of the *assurance team* and their *immediate* and *close family*. Further, if the *firm* had a material *financial interest*, whether direct or indirect, in the *assurance client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by *network firm* interests and relationships may be sufficient.
- 1.14 Accordingly:
- for *assurance engagements* provided to an *audit client*, the members of the *assurance team*, the *firm* and *network firms* are required to be independent of the client;
  - for *assurance engagements* provided to clients that are not *audit clients*, when the report is not expressly restricted for use by identified users, the members of the *assurance team* and the *firm* are required to be independent of the client; and
  - for *assurance engagements* provided to clients that are not *audit clients*, when the assurance report is expressly restricted for use by identified users, the members of the *assurance team* are required to be independent of the client. In addition, the *firm* should not have a material direct or *indirect financial interest* in the client.

These *independence* requirements for *assurance engagements* are illustrated as follows:

Client	Type of Assurance Engagement		
	Audit	Non-audit - not restricted use	Non-audit restricted use
<i>Audit client</i>	<i>Assurance team, firm and network firms</i>		
Non-audit <i>assurance client</i>		<i>Assurance team and firm</i>	<i>Assurance team and firm has no material financial interest</i>

- 1.15 The threats and safeguards identified in this appendix are generally discussed in the context of interests or relationships between the *firm*, *network firms*, a member of the *assurance team* and the *assurance client*. In the case of a listed *audit client*, the *firm* and any *network firms* are required to consider the interests and relationships that involve that client's *related entities*. Ideally those entities, and the interests and relationships should be identified in advance. For all other *assurance clients* when the *assurance team* has reason to believe that a *related entity* of such an *assurance client* is relevant to the evaluation of the *firm's independence* of the client, the *assurance team* should consider that *related entity* when evaluating *independence* and applying appropriate safeguards.
- 1.16 The evaluation of threats to *independence* and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a *firm*, a *network firm* or a member of the *assurance team* knows, or could reasonably be expected to know, of circumstances or relationships that might compromise *independence*. There may be occasions when the *firm*, a *network firm* or an individual inadvertently violates this appendix. If such an inadvertent violation occurs, it would generally not compromise *independence* with respect to an *assurance client* provided the *firm* has appropriate quality control policies and procedures in place to promote *independence* and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.
- 1.17 Throughout this appendix, reference is made to significant and clearly insignificant threats in the evaluation of *independence*. In considering the significance of any particular matter, qualitative as well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

## **Objective and Structure of this Appendix**

- 1.18 The objective of this appendix is in the context of assurance engagements to assist *firms* and members of *assurance teams* in:
- (a) identifying threats to *independence*;
  - (b) evaluating whether these threats are clearly insignificant; and
  - (c) in cases, when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.
- In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, to take all possible steps to resign from the audit engagement or to refuse to accept or continue the *assurance engagement*.
- 1.19 This appendix outlines in the context of *assurance engagements* the threats to *independence* (paragraphs 1.23 through 1.28). It then analyses safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraphs 1.29 through 1.42). A further appendix provides some examples of how this conceptual approach to *independence* is to be applied to specific circumstances and relationships. The examples discuss threats to *independence* that may be created by specific circumstances and relationships (paragraphs 2.1 through 2.112). Professional judgment is used to determine the appropriate safeguards to eliminate threats to *independence* or to reduce them to an acceptable level. In certain examples, the threats to *independence* are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the *assurance engagement*. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

- 1.20 When threats to *independence* that are not clearly insignificant are identified, and the *firm* decides to accept or continue the *assurance engagement*, the decision shall be documented and include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level. This documentation is to be produced at the time of a quality review conducted by the Institute/CPA Australia.
- 1.21 The evaluation of the significance of any threats to *independence* and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities might include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial reports of *listed entities* certain paragraphs in this appendix deal with additional matters that are relevant to the audit of *listed entities*. Consideration should be given to the application of the principles set out in this appendix in relation to the audit of *listed entities* to other *audit clients* that may be of significant public interest.
- 1.22 There can be instances where a client, being aware that the *firm*, or *network firm*, is not independent, nevertheless requires the *firm*, or *network firm*, to accept an *assurance engagement*. In such instances, any report provided or opinion expressed must clearly state that the *firm* is not independent.

### **Threats to *Independence***

- 1.23 *Independence* is potentially affected by self-interest, self-review, advocacy, familiarity and intimidation threats.
- 1.24 “Self-Interest Threat” occurs when a *firm* or a member of the *assurance team* could benefit from a *financial interest* in, or other self-interest conflict with, an *assurance client*.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) a *direct financial interest* or material *indirect financial interest* in an *assurance client*;
- (b) a loan or guarantee to or from an *assurance client* or any of its *directors* or *officers*;
- (c) undue dependence on total fees from an *assurance client*;
- (d) concern about the possibility of losing the engagement;
- (e) having a close business relationship with an *assurance client*;
- (f) potential employment with an *assurance client*; and
- (g) contingent fees relating to *assurance engagements*.

- 1.25 “Self-Review Threat” occurs when (1) any product or judgment of a previous *assurance engagement* or non-*assurance engagement* needs to be re-evaluated in reaching conclusions on the *assurance engagement* or (2) when a member of the *assurance team* was previously a *director* or *officer* of the *assurance client* or was an employee in a position to exert direct and significant influence over the subject matter of the *assurance engagement*.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) a member of the *assurance team* being, or having recently been, a *director* or *officer* of the *assurance client*;
- (b) a member of the *assurance team* being, or having recently been, an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement*;
- (c) performing services for an *assurance client* that directly affect the subject matter of the *assurance engagement*; and

(d) preparation of original data used to generate financial reports or preparation of other records that are the subject matter of the *assurance engagement*.

- 1.26 “Advocacy Threat” occurs when a *firm*, or a member of the *assurance team*, promotes, or may be perceived to promote an *assurance client’s* position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a *firm* or a member of the *assurance team* were to subordinate their judgment to that of the client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) dealing in, or being a promoter of, shares or other securities in an *assurance client*; and
- (b) acting as an advocate on behalf of an *assurance client* in litigation or in resolving disputes with third parties.

- 1.27 “Familiarity Threat” occurs when, by virtue of a close relationship with an *assurance client*, its *directors*, *officers* or employees, a *firm* or a member of the *assurance team* becomes too sympathetic to the client’s interests.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) a member of the *assurance team* having an *immediate family* member or *close family* member who is a *director* or *officer* of the *assurance client*;
- (b) a member of the *assurance team* having an *immediate family* member or *close family* member who, as an employee of the *assurance client*, is in a position to exert direct and significant influence over the subject matter of the *assurance engagement*;
- (c) a former partner of the *firm* being a *director*, *officer* of the *assurance client* or an employee in a position to exert direct and significant influence over the subject matter of the *assurance engagement*;
- (d) long association of a senior member of the *assurance team* with the *assurance client*; and
- (e) acceptance of gifts or hospitality, unless the value is clearly insignificant, from the *assurance client*, its *directors*, *officers* or employees.

- 1.28 “Intimidation Threat” occurs when a member of the *assurance team* may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the *directors*, *officers* or employees of an *assurance client*.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) threat of replacement over a disagreement with the application of an accounting principle; and
- (b) pressure to reduce inappropriately the extent of work performed in order to reduce fees.

## **Safeguards**

- 1.29 The *firm* and members of the *assurance team* have a responsibility to remain independent by taking into account the context in which they practise, the threats to *independence* and the safeguards available to eliminate the threats or reduce them to an acceptable level.
- 1.30 When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level. This decision should be documented. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the *assurance engagement*, the intended users of the assurance report and the structure of the *firm*.

- 1.31 Safeguards fall into three broad categories:
- (a) safeguards created by the profession, legislation or regulation;
  - (b) safeguards within the *assurance client*; and
  - (c) safeguards within the *firm's* own systems and procedures.
- The *firm* and the members of the *assurance team* should select appropriate safeguards to eliminate or reduce threats to *independence*, other than those that are clearly insignificant, to an acceptable level.
- 1.32 Safeguards created by the profession, legislation or regulation, include the following:
- (a) educational, training and experience requirements for entry into the profession;
  - (b) continuing education requirements;
  - (c) professional standards and monitoring and disciplinary processes;
  - (d) external review of a *firm's* quality control system; and
  - (e) legislation governing the *independence* requirements of the *firm*.
- 1.33 Safeguards within the *assurance client*, include the following:
- (a) when the *assurance client's* management appoints the *firm*, persons other than management ratify or approve the appointment;
  - (b) the *assurance client* has competent employees to make managerial decisions;
  - (c) policies and procedures that emphasize the *assurance client's* commitment to fair financial reporting;
  - (d) internal procedures that ensure objective choices in commissioning non-*assurance engagements*; and
  - (e) a corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a *firm's* services.
- 1.34 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of *Directors* in satisfying themselves that a *firm* is independent in carrying out its audit role. There should be regular communications between the *firm* and the audit committee (or other governance body if there is no audit committee) of *listed entities* regarding relationships and other matters that might, in the *firm's* opinion, reasonably be thought to bear on *independence*.
- 1.35 *Firms* should establish policies and procedures relating to *independence* communications with audit committees, or others charged with governance. In the case of the audit of *listed entities*, the *firm* should communicate orally, and in writing at least annually, all relationships and other matters between the *firm*, *network firms* and the *audit client* that, in the *firm's* professional judgment, may reasonably be thought to bear on *independence*. Matters to be communicated will vary in each circumstance and should be decided by the *firm*, but should generally address the relevant matters set out in this appendix.
- 1.36 Safeguards within the *firm's* own systems and procedures may include *firm-wide* safeguards such as the following:
- (a) *firm* leadership that stresses the importance of *independence* and the expectation that members of *assurance teams* will act in the public interest;
  - (b) policies and procedures to implement and monitor quality control of *assurance engagements*;
  - (c) documented *independence* policies regarding the identification of threats to *independence*, the evaluation of the significance of these threats and the identification and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level;

- (d) internal policies and procedures to monitor compliance with *firm* policies and procedures as they relate to *independence*;
- (e) policies and procedures that will enable the identification of interests or relationships between the *firm* or members of the *assurance team* and *assurance clients*;
- (f) policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single *assurance client*;
- (g) using different partners and teams with separate reporting lines for the provision of non-assurance services to an *assurance client*;
- (h) policies and procedures to prohibit individuals who are not members of the *assurance team* from influencing the outcome of the *assurance engagement*;
- (i) timely communication of a *firm's* policies and procedures, and any changes thereto, to all partners and professional staff, including appropriate training and education thereon;
- (j) designating a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
- (k) means of advising partners and professional staff of those *assurance clients* and related entities from which they must be independent;
- (l) a disciplinary mechanism to promote compliance with policies and procedures; and
- (m) policies and procedures to empower staff to communicate, to senior levels within the *firm*, any issue of *independence* and objectivity that concerns them; this includes informing staff of the procedures open to them.

- 1.37 Safeguards within the *firm's* own systems and procedures may include engagement specific safeguards such as the following:
- (a) involving an additional professional accountant to review the work done or otherwise advise as necessary. This individual could be someone from outside the *firm* or *network firm*, or someone within the *firm* or *network firm* who was not otherwise associated with the *assurance team*;
  - (b) consulting a third party, such as a committee of independent *directors*, a professional regulatory body or another professional accountant;
  - (c) rotation of senior personnel;
  - (d) discussing *independence* issues with the audit committee or others charged with governance;
  - (e) disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;
  - (f) policies and procedures to ensure members of the *assurance team* do not make, or assume responsibility for, management decisions for the *assurance client*;
  - (g) involving another *firm* to perform or re-perform part of the *assurance engagement*;
  - (h) involving another *firm* to re-perform the non-assurance service to the extent necessary to enable it to take responsibility for that service; and
  - (i) removing an individual from the *assurance team*, when that individual's *financial interests* or relationships create a threat to *independence*.

- 1.38 When the safeguards available, such as those described above, are insufficient to eliminate the threats to *independence* or to reduce them to an acceptable level, or when a *firm* chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or withdrawal from the *assurance engagement*.

## **Engagement Period**

- 1.39 The members of the *assurance team* and the *firm* should be independent of the *assurance client* during the period of the *assurance engagement*. The period of the engagement starts when the *assurance team* begins to perform assurance services and ends when the assurance report is issued, except when the *assurance engagement* is of a recurring nature. If the

*assurance engagement* is expected to recur, the period of the *assurance engagement* ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.

- 1.40 In the case of an *audit engagement*, the engagement period includes the period covered by the financial reports reported on by the *firm*. When an entity becomes an *audit client* during or after the period covered by the financial reports that the *firm* will report on, the *firm* should consider whether any threats to *independence* may be created by:
- financial or business relationships with the *audit client* during or after the period covered by the financial reports, but prior to the acceptance of the *audit engagement*; or
  - previous services provided to the *audit client*.

Similarly, in the case of an *assurance engagement* that is not an *audit engagement*, the *firm* should consider whether any financial or business relationships or previous services may create threats to *independence*.

- 1.41 If non-assurance services were provided to the *audit client* during or after the period covered by the financial reports but before the commencement of professional services in connection with the audit and those services would be prohibited during the period of the *audit engagement*, consideration should be given to the threats to *independence*, if any, arising from those services. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
- discussing *independence* issues related to the provision of the non-assurance services with those charged with governance of the client, such as the audit committee;
  - obtaining the *audit client's* acknowledgement of responsibility for the results of the non-assurance services;
  - precluding personnel who provided the non-assurance services from participating in the *audit engagement*; and
  - engaging another *firm* to review the results of the non-assurance services or having another *firm* re-perform the non-assurance services to the extent necessary to enable it to take responsibility for those services.

- 1.42 Non-assurance services provided to a non-listed *audit client* will not impair the *firm's independence* when the client becomes a *listed entity* provided:
- the previous non-assurance services were permissible under this appendix for non-listed *audit clients*;
  - the services will be terminated within a reasonable period of time of the client becoming a *listed entity*, if they are impermissible under this appendix for listed *audit clients*; and
  - the *firm* has implemented appropriate safeguards to eliminate any threats to *independence* arising from the previous services or reduce them to an acceptable level.

### **Effective Date**

- 1.43 This appendix is applicable to *assurance engagements* when the assurance report is dated on or after 31 December 2004. Earlier application is encouraged.

## Appendix 2

### Application of Principles to Specific Situations

<b>Index Subject</b>	<b>Paragraph</b>
Introduction	2.1
<i>Financial Interests</i>	2.3
Provisions Applicable to all <i>Assurance Clients</i>	2.5
Provisions Applicable to <i>Audit Clients</i>	2.12
Provisions Applicable to Non-Audit <i>Assurance Clients</i>	2.21
Loans and Guarantees	2.25
Close Business Relationships with <i>Assurance Clients</i>	2.31
Family and Personal Relationships	2.34
Employment with <i>Assurance Clients</i>	2.41
Recent Service with <i>Assurance Clients</i>	2.44
Serving as an <i>Officer</i> or <i>Director</i> on the Board of <i>Assurance Clients</i>	2.47
Long Association of Senior Personnel with <i>Assurance Clients</i>	2.49
General Provisions	2.49
<i>Audit Clients</i> that are <i>Listed Entities</i>	2.50
Provision of Non- <i>Assurance Services</i> to <i>Assurance Clients</i>	2.54
Preparing Accounting Records and Financial Statements	2.62
General Provisions	2.65
<i>Audit Clients</i> that are not <i>Listed Entities</i>	2.66
<i>Audit Clients</i> that are <i>Listed Entities</i>	2.67
Emergency Situations	2.69
Valuation Services	2.70
Provision of Taxation Services to <i>Audit Clients</i>	2.76
Provision of Internal Audit Services to <i>Audit Clients</i>	2.77
Provision of IT Systems Services to <i>Audit Clients</i>	2.83
Temporary Staff Assignments to <i>Audit Clients</i>	2.88
Provision of Litigation Support Services to <i>Audit Clients</i>	2.89
Provision of Legal Services to <i>Audit Clients</i>	2.92
Recruiting Senior Management	2.99
Corporate Finance and Similar Activities	2.100
Fees and Pricing	
Fees – Relative Size	2.102
Fees – Overdue	2.105
Pricing	2.106
Contingent Fees	2.107
Gifts and Hospitality	2.111
Actual or Threatened Litigation	2.112

## Introduction

- 2.1 The following examples describe specific circumstances and relationships that may create threats to *independence*. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all-inclusive. In practice, the *firm*, *network firms* and the members of the *assurance team* will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 1.32 through 1.37 can be applied to satisfactorily address the threats to *independence*. Paragraphs 1.1 through 1.42 of this appendix provide conceptual guidance to assist in this process.
- 2.2 Some of the examples deal with *audit clients* while others deal with *assurance clients* that are not *audit clients*. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the *assurance team*, the *firm* and *network firms* to be independent of an *audit client*, and for the members of the *assurance team* and the *firm* to be independent of an *assurance client* that is not an *audit client*. The examples do not include assurance reports to a non-audit *assurance client* expressly restricted for use by identified users. As stated in paragraph 1.13 for such engagements, members of the *assurance team* and their immediate and *close family* are required to be independent of the *assurance client*. Further the *firm* should not have a material *financial interest*, direct or indirect, in the *assurance client*.

## Financial Interests

- 2.3 A *financial interest* in an *assurance client* may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the *financial interest*. This includes an evaluation of the role of the person holding the *financial interest*, the materiality of the *financial interest* and the type of *financial interest* (direct or indirect).
- 2.4 When evaluating the type of *financial interest*, consideration should be given to the fact that *financial interests* range from those where the individual has no control over the investment vehicle or the *financial interest* held (e.g. a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the *financial interest* (e.g. as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to *independence*, it is important to consider the degree of control or influence that can be exercised over the intermediary, the *financial interest* held, or its investment strategy. When control exists, the *financial interest* should be considered direct. Conversely, when the holder of the *financial interest* has no ability to exercise such control the *financial interest* should be considered indirect.

## Provisions Applicable to all Assurance Clients

- 2.5 If a member of the *assurance team*, or their *immediate family* member, has a *direct financial interest*, or a material *indirect financial interest*, in the *assurance client*, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:
- dispose of the *direct financial interest* prior to the individual becoming a member of the *assurance team*;
  - dispose of the *indirect financial interest* in total or dispose of a sufficient amount of it so that the remaining

- interest is no longer material prior to the individual becoming a member of the *assurance team*; or
- remove the member of the *assurance team* from the *assurance engagement*.

2.6 If a member of the *assurance team*, or their *immediate family* member receives, by way of, for example, an inheritance, gift or as a result of a merger, a *direct financial interest* or a material *indirect financial interest* in the *assurance client*, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

- disposing of the *financial interest* at the earliest practical date; or
- removing the member of the *assurance team* from the *assurance engagement*.

During the period prior to disposal of the *financial interest* or the removal of the individual from the *assurance team*, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- discussing the matter with those charged with governance, such as the audit committee; or
- involving an additional professional accountant to review the work done, or otherwise advise as necessary.

2.7 When a member of the *assurance team* knows that his or her *close family* member has a *direct financial interest* or a material *indirect financial interest* in the *assurance client*, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the *assurance team* and the *close family* member and the materiality of the *financial interest*. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- the *close family* member disposing of all or a sufficient portion of the *financial interest* at the earliest practical date;
- discussing the matter with those charged with governance, such as the audit committee;
- involving an additional professional accountant who did not take part in the *assurance engagement* to review the work done by the member of the *assurance team* with the *close family* relationship or otherwise advise as necessary; or
- removing the individual from the *assurance engagement*.

2.8 When a firm or a member of the *assurance team* holds a *direct financial interest* or a material *indirect financial interest* in the *assurance client* as a trustee, a self-interest threat may be created by the possible influence of the trust over the *assurance client*. Accordingly, such an interest should only be held when:

- the member of the *assurance team*, an *immediate family* member of the member of the *assurance team*, and the *firm* are not beneficiaries of the trust;
- the interest held by the trust in the *assurance client* is not material to the trust;
- the trust is not able to exercise significant influence over the *assurance client*; and
- the member of the *assurance team* or the *firm* does not have significant influence over any investment decision involving a *financial interest* in the *assurance client*.

2.9 Consideration should be given to whether a self-interest threat may be created by the *financial interests* of individuals outside of the *assurance team* and their immediate and *close family* members. Such individuals would include:

- partners, and their *immediate family* members, who are not members of the *assurance team*;
- partners and managerial employees who provide non-*assurance services* to the *assurance client*; and

- individuals who have a close personal relationship with a member of the *assurance team*.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- the *firm's* organisational, operating and reporting structure; and
- the nature of the relationship between the individual and the member of the *assurance team*.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- where appropriate, policies to restrict people from holding such interests;
- discussing the matter with those charged with governance, such as the audit committee; or
- involving an additional professional accountant who did not take part in the *assurance engagement* to review the work done or otherwise advise as necessary.

- 2.10 An inadvertent violation of this Statement as it relates to a *financial interest* in an *assurance client* would not impair the *independence* of the *firm*, the *network firm* or a member of the *assurance team* when:
- (a) the *firm*, and the *network firm*, has established policies and procedures that require all professionals to report promptly to the *firm* any breaches resulting from the purchase, inheritance or other acquisition of a *financial interest* in the *assurance client*;
  - (b) the *firm*, and the *network firm*, promptly notifies the professional that the *financial interest* should be disposed of; and
  - (c) the disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the *assurance team*.
- 2.11 When an inadvertent violation of this Statement relating to a *financial interest* in an *assurance client* has occurred, the *firm* should consider whether any safeguards should be applied. Such safeguards might include:
- involving an additional professional accountant who did not take part in the *assurance engagement* to review the work done by the member of the *assurance team*; or
  - excluding the individual from any substantive decision-making concerning the *assurance engagement*.

## **Provisions Applicable to Audit Clients**

- 2.12 If a *firm*, or a *network firm*, has a *direct financial interest* in an *audit client* of the *firm* the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the *financial interest* would be the only action appropriate to permit the *firm* to perform the engagement.
- 2.13 If a *firm*, or a *network firm*, has a material *indirect financial interest* in an *audit client* of the *firm* a self-interest threat is also created. The only actions appropriate to permit the *firm* to perform the engagement would be for the *firm*, or the *network firm*, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 2.14 If a *firm*, or a *network firm*, has a material *financial interest* in an entity that has a controlling interest in an *audit client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the *firm*, to perform the engagement would be for the *firm*, or the *network firm*, either to dispose of the

*financial interest* in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

- 2.15 If the superannuation fund of a *firm*, or *network firm*, has a *financial interest* in an *audit client* a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.
- 2.16 If other partners, including partners who do not perform *assurance engagements*, or their *immediate family*, in the *office* in which the *lead engagement partner* practises in connection with the audit, hold a *direct financial interest* or a material *indirect financial interest* in that *audit client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their *immediate family* should not hold any such *financial interests* in such an *audit client*.
- 2.17 The *office* in which the *lead engagement partner* practises in connection with the audit is not necessarily the *office* to which that partner is assigned. Accordingly, when the *lead engagement partner* is located in a different *office* from that of the other members of the *assurance team*, judgment should be used to determine in which *office* the partner practises in connection with that audit.
- 2.18 If other partners and managerial employees who provide non-assurance services to the *audit client*, except those whose involvement is clearly insignificant, or their *immediate family*, hold a *direct financial interest* or a material *indirect financial interest* in the *audit client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their *immediate family* should not hold any such *financial interests* in such an *audit client*.
- 2.19 A *financial interest* in an *audit client* that is held by an *immediate family* member of (a) a partner located in the *office* in which the *lead engagement partner* practises in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the *audit client*, is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g. pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to *independence* to an acceptable level.
- 2.20 A self-interest threat may be created if the *firm*, or the *network firm*, or a member of the *assurance team* has an interest in an entity and an *audit client*, or a *director, officer* or controlling owner thereof also has an investment in that entity. *Independence* is not compromised with respect to the *audit client* if the respective interests of the *firm*, the *network firm*, or member of the *assurance team*, and the *audit client*, or *director, officer* or controlling owner thereof are both immaterial and the *audit client* cannot exercise significant influence over the entity. If an interest is material, to either the *firm*, the *network firm* or the *audit client*, and the *audit client* can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the *firm*, the *network firm*, should either dispose of the interest or decline the *audit engagement*. Any member of the *assurance team* with such a material interest should either:
- dispose of the interest;
  - dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or
  - withdraw from the audit.

## **Provisions Applicable to Non-Audit Assurance Clients**

- 2.21 If a *firm* has a *direct financial interest* in an *assurance client* that is not an *audit client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the *financial interest* would be the only action appropriate to permit the *firm* to perform the engagement.
- 2.22 If a *firm* has a material *indirect financial interest* in an *assurance client* that is not an *audit client* a self-interest threat is also created. The only action appropriate to permit the *firm* to perform the engagement would be for the *firm* to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 2.23 If a *firm* has a material *financial interest* in an entity that has a controlling interest in an *assurance client* that is not an *audit client*, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the *firm* to perform the engagement would be for the *firm* either to dispose of the *financial interest* in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.
- 2.24 When a restricted use report for an *assurance engagement* that is not an *audit engagement* is issued, exceptions to the provisions in paragraphs 2.5 through 2.9 and 2.21 through 2.23 are set out in 1.13.

## Loans and Guarantees

- 2.25 A loan from, or a guarantee thereof by, an *assurance client*, that is a financial institution, to the *firm* would not create a threat to *independence* provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the *firm* and the *assurance client*. If the loan is material to the *assurance client* or the *firm* it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the *firm*, or *network firm*, to review the work performed.
- 2.26 A loan from, or a guarantee thereof by, an *assurance client* that is a financial institution, to a member of the *assurance team* or their *immediate family* would not create a threat to *independence* provided the loan is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.
- 2.27 Similarly, deposits made by, or brokerage accounts of, a *firm* or a member of the *assurance team* with an *assurance client* that is a financial institution would not create a threat to *independence* provided the deposit or account is held under normal commercial terms.
- 2.28 If the *firm*, or a member of the *assurance team*, makes a loan to an *assurance client*, that is not a financial institution, or guarantees such an *assurance client's* borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the *firm* or the member of the *assurance team* and the *assurance client*.
- 2.29 Similarly, if the *firm* or a member of the *assurance team* accepts a loan from, or has borrowing guaranteed by, an *assurance client* that is not a financial institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the *firm* or the member of the *assurance team* and the *assurance client*.

- 2.30 The examples in paragraphs 2.25 through 2.29 relate to loans and guarantees between the *firm* and an *assurance client*. In the case of an *audit engagement* the provisions should be applied to the *firm*, all *network firms* and the *audit client*.

## Close Business Relationships with Assurance Clients

- 2.31 A close business relationship between a *firm* or a member of the *assurance team* and the *assurance client* or its management, or between the *firm*, a *network firm* and an *audit client*, will involve a commercial or common *financial interest* and may create self-interest and intimidation threats. The following are examples of such relationships:

- (a) having a material *financial interest* in a joint venture with the *assurance client* or a controlling owner, *director*, *officer* or other individual who performs senior managerial functions for that client;
- (b) arrangements to combine one or more services or products of the *firm* with one or more services or products of the *assurance client* and to market the package with reference to both parties; and
- (c) distribution or marketing arrangements under which the *firm* acts as a distributor or marketer of the *assurance client's* products or services, or the *assurance client* acts as the distributor or marketer of the products or services of the *firm*.

In the case of an *audit client*, unless the *financial interest* is immaterial and the relationship is clearly insignificant to the *firm*, the *network firm* and the *audit client*, no safeguards could reduce the threat to an acceptable level. In the case of an *assurance client* that is not an *audit client*, unless the *financial interest* is immaterial and the relationship is clearly insignificant to the *firm* and the *assurance client*, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

- terminate the business relationship,
- reduce the magnitude of the relationship so that the *financial interest* is immaterial and the relationship is clearly insignificant; or
- refuse to perform the *assurance engagement*.

Unless any such *financial interest* is immaterial and the relationship is clearly insignificant to the member of the *assurance team* the only appropriate safeguard would be to remove the individual from the *assurance team*.

- 2.32 In the case of an *audit client*, business relationships involving an interest held by the *firm*, a *network firm* or a member of the *assurance team* or their *immediate family* in a closely held entity when the *audit client* or a *director* or *officer* of the *audit client*, or any group thereof, also has an interest in that entity do not create threats to *independence* provided:

- the relationship is clearly insignificant to the *firm*, the *network firm* and the *audit client*;
- the interest held is immaterial to the investor, or group of investors; and
- the interest does not give the investor, or group of investors, the ability to control the closely held entity.

- 2.33 The purchase of goods and services from an *assurance client* by the *firm* (or from an *audit client* by a *network firm*) or a member of the *assurance team* would not generally create a threat to *independence* providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- eliminating or reducing the magnitude of the transaction;
- removing the individual from the *assurance team*; or

- discussing the issue with those charged with governance, such as the audit committee.

## Family and Personal Relationships

- 2.34 Family and personal relationships between a member of the *assurance team* and a *director*, an *officer* or certain employees, depending on their role, of the *assurance client*, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the *assurance engagement*, the closeness of the relationship and the role of the family member or other individual within the *assurance client*. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.
- 2.35 When an *immediate family* member of a member of the *assurance team* is a *director*, an *officer* or an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement*, or was in such a position during any period covered by the engagement, the threats to *independence* can only be reduced to an acceptable level by removing the individual from the *assurance team*. The closeness of the relationship is such that no other safeguard could reduce the threat to *independence* to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the *assurance engagement*. For example, in the case of an audit of financial reports, if the spouse of a member of the *assurance team* is an employee in a position to exert direct and significant influence on the preparation of the *audit client's* accounting records or financial reports, the threat to *independence* could only be reduced to an acceptable level by removing the individual from the *assurance team*.
- 2.36 When a *close family* member of a member of the *assurance team* is a *director*, an *officer*, or an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement*, threats to *independence* may be created. The significance of the threats will depend on factors such as:
- the position the *close family* member holds with the client; and
  - the role of the professional on the *assurance team*.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- removing the individual from the *assurance team*;
  - where possible, structuring the responsibilities of the *assurance team* so that the professional does not deal with matters that are within the responsibility of the *close family* member; or
  - policies and procedures to empower staff to communicate to senior levels within the *firm* any issue of *independence* and objectivity that concerns them.
- 2.37 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or *close family* member of a member of the *assurance team* has a close relationship with the member of the *assurance team* and is a *director*, an *officer* or an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement*. Therefore, members of the *assurance team* are responsible for identifying any such persons and for consulting in accordance with *firm* procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering

matters such as the closeness of the relationship and the role of the individual within the *assurance client*.

- 2.38 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the *firm* who is not a member of the *assurance team* and a *director*, an *officer* or an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement*. Therefore partners and employees of the *firm* are responsible for identifying any such relationships and for consulting in accordance with *firm* procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the *assurance team*, the position held within the *firm*, and the role of the individual within the *assurance client*.
- 2.39 An inadvertent violation of this appendix as it relates to family and personal relationships would not impair the *independence* of a *firm* or a member of the *assurance team* when:
- (a) the *firm* has established policies and procedures that require all professionals to report promptly to the *firm* any breaches resulting from changes in the employment status of their immediate or *close family* members or other personal relationships that create threats to *independence*;
  - (b) either the responsibilities of the *assurance team* are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the *firm* promptly removes the professional from the *assurance engagement*; and
  - (c) additional care is given to reviewing the work of the professional.
- 2.40 When an inadvertent violation of this Statement relating to family and personal relationships has occurred, the *firm* should consider whether any safeguards should be applied. Such safeguards might include:
- involving an additional professional accountant who did not take part in the *assurance engagement* to review the work done by the member of the *assurance team*; or
  - excluding the individual from any substantive decision-making concerning the *assurance engagement*.

## **Employment with Assurance Clients**

- 2.41 A *firm* or a member of the *assurance team's independence* may be threatened if a *director*, an *officer* or an employee of the *assurance client* in a position to exert direct and significant influence over the subject matter of the *assurance engagement* has been a member of the *assurance team* or partner of the *firm*. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former *firm*. Similarly, a member of the *assurance team's independence* may be threatened when an individual participates in the *assurance engagement* knowing, or having reason to believe, that he or she is to, or may, join the *assurance client* some time in the future.
- 2.42 If a member of the *assurance team*, partner or former partner of the *firm* has joined the *assurance client*, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:
- the position the individual has taken at the *assurance client*;
  - the amount of any involvement the individual will have with the *assurance team*;
  - the length of time that has passed since the individual was a member of the *assurance team* or *firm*; and

- the former position of the individual within the *assurance team* or *firm*.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- considering the appropriateness or necessity of modifying the assurance plan for the *assurance engagement*;
- assigning an *assurance team* to the subsequent *assurance engagement* that is of sufficient experience in relation to the individual who has joined the *assurance client*;
- involving an additional professional accountant who was not a member of the *assurance team* to review the work done or otherwise advise as necessary; or
- quality control review of the *assurance engagement*.

In all cases all of the following safeguards are necessary to reduce the threat to an acceptable level:

- the individual concerned is not entitled to any benefits or payments from the *firm* unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the *firm's independence*;
- the individual does not continue to participate or appear to participate in the *firm's* business or professional activities; and
- where a former partner of the *firm*, who was directly involved in the audit, has joined the board of the *audit client*, at least two years has elapsed.

- 2.43 A self-interest threat is created when a member of the *assurance team* participates in the *assurance engagement* while knowing, or having reason to believe, that he or she is to, or may, join the *assurance client* some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:
- policies and procedures to require the individual to notify the *firm* when entering serious employment negotiations with the *assurance client*; and
  - removal of the individual from the *assurance engagement*.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

## **Recent Service with Assurance Clients**

- 2.44 To have a former *officer, director* or employee of the *assurance client* serve as a member of the *assurance team* may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the *assurance team* has to report on, for example, subject matter he or she had prepared or elements of the financial reports he or she had valued while with the *assurance client*.
- 2.45 If, during the period covered by the assurance report, a member of the *assurance team* had served as an *officer* or *director* of the *assurance client*, or had been an employee in a position to exert direct and significant influence over the subject matter of the *assurance engagement*, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the *assurance team*.
- 2.46 If, prior to the period covered by the assurance report, a member of the *assurance team* had served as an *officer* or *director* of the *assurance client*, or had been an employee in a position to exert direct and significant influence over the subject matter of the *assurance engagement*, this may create self-interest, self-review and familiarity threats. For example, such threats

would be created if a decision made or work performed by the individual in the prior period, while employed by the *assurance client*, is to be evaluated in the current period as part of the current *assurance engagement*. The significance of the threats will depend upon factors such as:

- the position the individual held with the *assurance client*;
- the length of time that has passed since the individual left the *assurance client*; and
- the role the individual plays on the *assurance team*.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- involving an additional professional accountant to review the work done by the individual as part of the *assurance team* or otherwise advise as necessary; or
- discussing the issue with those charged with governance, such as the audit committee.

## **Serving as an Officer or Director on the Board of Assurance Clients**

- 2.47 If a partner or employee of the *firm* serves as an *officer* or as a *director* on the board or as a liquidator, provisional liquidator, controller, scheme manager, official manager or administrator of an *assurance client* the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of an *audit engagement*, if a partner or employee of a *network firm* were to serve as an *officer* or as a *director* on the board of an *audit client* the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the *assurance engagement*.
- 2.48 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair *independence*, provided client management makes all relevant decisions.

## **Long Association of Senior Personnel with Assurance Clients**

### **General Provisions**

- 2.49 Using the same senior personnel on an *assurance engagement* over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:
- the length of time that the individual has been a member of the *assurance team*;
  - the role of the individual on the *assurance team*;
  - the structure of the *firm*; and
  - the nature of the *assurance engagement*.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- rotating the senior personnel off the *assurance team*;
- involving an additional professional accountant who was not a member of the *assurance team* to review the work done by the senior personnel or otherwise advise as necessary; or
- independent internal quality reviews.

### **Audit Clients that are Listed Entities**

- 2.50 Using the same *lead engagement partner* on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of *listed entities* and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly for the audit of *listed entities*:
- (a) the *lead engagement partner* should be rotated after a pre-defined period, no longer than seven years; and
  - (b) a partner rotating after a pre-defined period should not resume the *lead engagement partner* role until a further period of time, no less than two years, has elapsed.
- 2.51 When an *audit client* becomes a *listed entity* the length of time the *lead engagement partner* has served the *audit client* in that capacity should be considered in determining when the partner should be rotated. However, the partner may continue to serve as the *lead engagement partner* for two additional years before rotating off the engagement.

- 2.52 While the *lead engagement partner* should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:
- situations when the *lead engagement partner's* continuity is especially important to the *audit client*, for example, when there will be major changes to the *audit client's* structure that would otherwise coincide with the rotation of the *lead engagement partner*; and
  - situations when, due to the size of the *firm*, rotation is not possible or does not constitute an appropriate safeguard.
- In all such circumstances when the *lead engagement partner* is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.
- 2.53 When a *firm* has only a few audit partners with the necessary knowledge and experience to serve as *lead engagement partner* on an *audit client* that is a *listed entity*, rotation of the lead partner may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the *assurance team* to review the work done or otherwise advise as necessary. This individual could be someone from outside the *firm* or someone within the *firm* who was not otherwise associated with the *assurance team*.

## **Provision of Non-Assurance Services to Assurance Clients**

- 2.54 *Firms* have traditionally provided to their *assurance clients* a range of non-assurance services that are consistent with their skills and expertise. *Assurance clients* value the benefits that derive from having these *firms*, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the *assurance team* obtaining information regarding the *assurance client's* business and operations that is helpful in relation to the *assurance engagement*. The greater the knowledge of the *assurance client's* business, the better the *assurance team* will understand the *assurance client's* procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the *independence* of the *firm*, a *network firm* or the members of the *assurance team*, particularly with respect to perceived threats to *independence*. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.
- 2.55 The following activities would create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the *assurance engagement* would reduce the threats to an acceptable level:
- authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the *assurance client*, or having the authority to do so;
  - determining which recommendation of the *firm* should be implemented; and
  - reporting, in a management role, to those charged with governance; and
  - any other activity barred by legislation (for example acting as a liquidator, provisional liquidator, controller, scheme manager, official manager or administrator of the *assurance client* within the previous two years).
- 2.56 The examples set out in paragraphs 2.62 through 2.101 are addressed in the context of the provision of non-assurance services to an *assurance client*. The potential threats to *independence* will most frequently arise when a non-assurance service is provided to an *audit client*. The financial reports of an entity provide financial information about a broad range of

transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to *independence*, however, may also arise when a *firm* provides a non-assurance service related to the subject matter of a non-audit *assurance engagement*. In such cases, consideration should be given to the significance of the *firm's* involvement with the subject matter of the non-audit *assurance engagement*, whether any self-review threats are created and whether any threats to *independence* could be reduced to an acceptable level by application of safeguards, or whether the non-*assurance engagement* should be declined. When the non-assurance service is not related to the subject matter of the non-audit *assurance engagement*, the threats to *independence* will generally be clearly insignificant.

2.57 The following activities may also create self-review or self-interest threats:

- having custody of an *assurance client's* assets;
- supervising *assurance client* employees in the performance of their normal recurring activities; and
- preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- making arrangements so that personnel providing such services do not participate in the *assurance engagement*;
- involving an additional professional accountant to advise on the potential impact of the activities on the *independence* of the *firm* and the *assurance team*; or
- other relevant safeguards set out in national regulations.

2.58 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an *assurance client* might create threats to *independence* and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a *firm* may provide services beyond the *assurance engagement* provided any threats to *independence* have been reduced to an acceptable level.

2.59 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to *assurance clients*:

- policies and procedures to prohibit professional staff from making management decisions for the *assurance client*, or assuming responsibility for such decisions;
- discussing *independence* issues related to the provision of non-assurance services with those charged with governance, such as the audit committee;
- policies within the *assurance client* regarding the oversight responsibility for provision of non-assurance services by the *firm*;
- involving an additional professional accountant to advise on the potential impact of the non-*assurance engagement* on the *independence* of the member of the *assurance team* and the *firm*;
- involving an additional professional accountant outside of the *firm* to provide assurance on a discrete aspect of the *assurance engagement*;
- obtaining the *assurance client's* acknowledgement of responsibility for the results of the work performed by the *firm*;
- disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; or

- making arrangements so that personnel providing non-assurance services do not participate in the *assurance engagement*.
- 2.60 Before the *firm* accepts an engagement to provide a non-assurance service to an *assurance client*, consideration should be given to whether the provision of such a service would create a threat to *independence*. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.
- 2.61 The provision of certain non-assurance services to *audit clients* may create threats to *independence* so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a *related entity*, division or discrete financial report item of such clients may be permissible when any threats to the *firm's independence* have been reduced to an acceptable level by arrangements for that *related entity*, division or discrete financial report item to be audited by another *firm* or when another *firm* re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

## Preparing Accounting Records and Financial Reports

- 2.62 Assisting an *audit client* in matters such as preparing accounting records or financial reports may create a self-review threat when the financial reports are subsequently audited by the *firm*.
- 2.63 It is the responsibility of client management to ensure that accounting records are kept and financial reports are prepared, although they may request the *firm* to provide assistance. If *firm*, or *network firm*, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include the following:
- determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the *audit client*;
  - authorizing or approving transactions; and
  - preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.
- 2.64 The audit process involves extensive dialogue between the *firm* and management of the *audit client*. During this process, management requests and receives significant input regarding such matters as accounting principles and financial report disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for *audit clients* are an appropriate means to promote the fair presentation of the financial reports. The provision of such advice does not generally threaten the *firm's independence*. Similarly, the audit process may involve assisting an *audit client* in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial reports (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Accounting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten *independence*.

## General Provisions

- 2.65 The examples in paragraphs 2.66 through 2.69 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial reports and those financial reports are subsequently the subject matter of an *audit engagement* of the *firm*. This notion may be equally applicable in situations when the subject matter of the *assurance engagement* is not financial reports. For example, a self-review threat would be created if the *firm* developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

#### *Audit Clients* that are not Listed Entities

- 2.66 The *firm*, or a *network firm*, may provide an *audit client* that is not a *listed entity* with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:
- recording transactions for which the *audit client* has determined or approved the appropriate account classification;
  - posting coded transactions to the *audit client's* general ledger;
  - preparing financial reports based on information in the trial balance; and
  - posting *audit client* approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- making arrangements so such services are not performed by a member of the *assurance team*;
- implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the *audit client*;
- requiring the source data for the accounting entries to be originated by the *audit client*;
- requiring the underlying assumptions to be originated and approved by the *audit client*; or
- obtaining *audit client* approval for any proposed journal entries or other changes affecting the financial reports.

#### *Audit Clients* that are Listed Entities

- 2.67 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial reports or financial information which forms the basis of the financial reports on which the audit report is provided, on behalf of an *audit client* that is a *listed entity*, may impair the *independence* of the *firm* or *network firm*, or at least give the appearance of impairing *independence*. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a *firm* or a *network firm* should not, with the limited exceptions below, provide such services to *listed entities* which are *audit clients*.
- 2.68 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed *audit clients* would not be seen as impairing *independence* with respect to the *audit client* provided that the following conditions are met:
- the services do not involve the exercise of judgment;

- the divisions or subsidiaries for which the service is provided are collectively immaterial to the *audit client*, or the services provided are collectively immaterial to the division or subsidiary; and
- the fees to the *firm*, or *network firm*, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

- the *firm*, or *network firm*, should not assume any managerial role nor make any managerial decisions;
- the listed *audit client* should accept responsibility for the results of the work; and
- personnel providing the services should not participate in the audit.

## Emergency Situations

- 2.69 The provision of accounting and bookkeeping services to *audit clients* in emergency or other unusual situations, when it is impractical for the *audit client* to make other arrangements, would not be considered to pose an unacceptable threat to *independence* provided:
- the *firm*, or *network firm*, does not assume any managerial role or make any managerial decisions;
  - the *audit client* accepts responsibility for the results of the work; and
  - personnel providing the services are not members of the *assurance team*.

## Valuation Services

- 2.70 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.
- 2.71 A self-review threat may be created when a *firm* or *network firm* performs a valuation for an *audit client* that is to be incorporated into the client's financial reports.
- 2.72 If the valuation service involves the valuation of matters material to the financial reports and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the *audit engagement*.
- 2.73 Performing valuation services that are neither separately, nor in the aggregate, material to the financial reports, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:
- involving an additional professional accountant who was not a member of the *assurance team* to review the work done or otherwise advise as necessary;
  - confirming with the *audit client* their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
  - obtaining the *audit client's* acknowledgement of responsibility for the results of the work performed by the *firm*; and
  - making arrangements so that personnel providing such services do not participate in the *audit engagement*.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

- the extent of the *audit client's* knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment;
- the degree to which established methodologies and professional guidelines are applied when performing a particular valuation service;
- for valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned;
- the reliability and extent of the underlying data;
- the degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved; and
- the extent and clarity of the disclosures in the financial reports.

- 2.74 When a *firm*, or a *network firm*, performs a valuation service for an *audit client* for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the *assurance client* or for the purpose of tax planning this would not create a significant threat to *independence* because such valuations are generally subject to external review, for example by a tax authority.
- 2.75 When the *firm* performs a valuation that forms part of the subject matter of an *assurance engagement* that is not an *audit engagement*, the *firm* should consider any self-review threats. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

### **Provision of Taxation Services to *Audit Clients***

- 2.76 In many jurisdictions, the *firm* may be asked to provide taxation services to an *audit client*. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to *independence*.

### **Provision of Internal Audit Services to *Audit Clients***

- 2.77 A self-review threat may be created when a *firm*, or *network firm*, provides internal audit services to an *audit client*. Internal audit services may comprise an extension of the *firm's* audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to *independence*, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial reports.
- 2.78 Services involving an extension of the procedures required to conduct an audit in accordance with Auditing Statements would not be considered to impair *independence* with respect to an *audit client* provided that the *firm's* or *network firm's* personnel do not act or appear to act in a capacity equivalent to a member of *audit client* management.
- 2.79 When the *firm*, or a *network firm*, provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by *audit client* management and the internal audit activities themselves.
- 2.80 Performing a significant portion of the *audit client's* internal audit activities may create a self-review threat and a *firm*, or *network firm*, should consider the threats and proceed with

caution before taking on such activities. Appropriate safeguards should be put in place and the *firm*, or *network firm*, should, in particular, ensure that the *audit client* acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.

- 2.81 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:
- (a) the *audit client* is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
  - (b) the *audit client* designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
  - (c) the *audit client*, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
  - (d) the *audit client* is responsible for evaluating and determining which recommendations of the *firm* should be implemented;
  - (e) the *audit client* evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the *firm*; and
  - (f) the findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.
- 2.82 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the *audit engagement* and with different reporting lines within the *firm*.

### **Provision of IT Systems Services to Audit Clients**

- 2.83 The provision of services by a *firm* or *network firm* to an *audit client* that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial reports may create a self-review threat.
- 2.84 The self-review threat is likely to be too significant to allow the provision of such services to an *audit client* unless appropriate safeguards are put in place ensuring that:
- (a) the *audit client* acknowledges its responsibility for establishing and monitoring a system of internal controls;
  - (b) the *audit client* designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
  - (c) the *audit client* makes all management decisions with respect to the design and implementation process;
  - (d) the *audit client* evaluates the adequacy and results of the design and implementation of the system; and
  - (e) the *audit client* is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- 2.85 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the *audit engagement* and with different reporting lines within the *firm*.
- 2.86 The provision of services by a *firm* or *network firm* to an *audit client* which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial reports may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than

clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

- 2.87 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to *independence* provided that *firm* or *network firm* personnel do not perform management functions.

### **Temporary Staff Assignments to *Audit Clients***

- 2.88 The lending of staff by a *firm*, or *network firm*, to an *audit client* may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial reports. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the *firm's* or *network firm's* personnel will not be involved in:
- (a) making management decisions;
  - (b) approving or signing agreements or other similar documents; or
  - (c) exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- the staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and
- the *audit client* should acknowledge its responsibility for directing and supervising the activities of *firm*, or *network firm*, personnel.

### **Provision of Litigation Support Services to *Audit Clients***

- 2.89 Litigation support services may include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.
- 2.90 A self-review threat may be created when the litigation support services provided to an *audit client* include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial reports. The significance of any threat created will depend upon factors such as:
- the materiality of the amounts involved;
  - the degree of subjectivity inherent in the matter concerned; and
  - the nature of the engagement.

The *firm*, or *network firm*, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- policies and procedures to prohibit individuals assisting the *audit client* from making managerial decisions on behalf of the client;
- using professionals who are not members of the *assurance team* to perform the service; or
- the involvement of others, such as independent experts.

- 2.91 If the role undertaken by the *firm*, or *network firm*, involved making managerial decisions on behalf of the *audit client* the threats created could not be reduced to an acceptable level by the

application of any safeguard. Therefore, the *firm*, or *network firm*, should not perform this type of service for an *audit client*.

## **Provision of Legal Services to *Audit Clients***

- 2.92 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided or have the required legal training to practise law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a *firm*, or *network firm*, to an entity that is an *audit client* may create both self-review and advocacy threats.
- 2.93 Threats to *independence* need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the *assurance team* and the materiality of any matter in relation to the entities' financial reports. The safeguards set out in paragraph 2.59 may be appropriate in reducing any threats to *independence* to an acceptable level. In circumstances when the threat to *independence* cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the *audit engagement*.
- 2.94 The provision of legal services to an *audit client* which involve matters that would not be expected to have a material effect on the financial reports are not considered to create an unacceptable threat to *independence*.
- 2.95 There is a distinction between advocacy and advice. Legal services to support an *audit client* in the execution of a transaction (e.g. contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair *independence*, provided that
- members of the *assurance team* are not involved in providing the service; and
  - in relation to the advice provided, the *audit client* makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the *audit client*.
- 2.96 Acting for an *audit client* in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial reports of the *audit client* would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the *firm* should not perform this type of service for an *audit client*.
- 2.97 When a *firm* is asked to act in an advocacy role for an *audit client* in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial reports of the *audit client*, the *firm* should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:
- policies and procedures to prohibit individuals assisting the *audit client* from making managerial decisions on behalf of the client; or
  - using professionals who are not members of the *assurance team* to perform the service.

- 2.98 The appointment of a partner or an employee of the *firm* or *network firm* as General Counsel for legal affairs to an *audit client* would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the *firm* or *network firm* may accept such an appointment for an *audit client*.

## Recruiting Senior Management

- 2.99 The recruitment of senior management for an *assurance client*, such as those in a position to affect the subject of the *assurance engagement*, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as
- the role of the person to be recruited; and
  - the nature of the assistance sought.

The *firm* could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition the *firm* could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the *assurance client*.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the *firm* should not make management decisions and the decision as to whom to hire should be left to the client.

## Corporate Finance and Similar Activities

- 2.100 The provision of corporate finance services, advice or assistance to an *assurance client* may create advocacy and self-review threats. In the case of certain corporate finance services, the *independence* threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an *assurance client's* shares is not compatible with providing assurance services. Moreover, committing the *assurance client* to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to *independence* so significant no safeguard could reduce the threat to an acceptable level. In the case of an *audit client* the provision of those corporate finance services referred to above by a *firm* or a *network firm* would create a threat to *independence* so significant no safeguard could reduce the threat to an acceptable level.
- 2.101 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:
- policies and procedures to prohibit individuals assisting the *assurance client* from making managerial decisions on behalf of the client;
  - using professionals who are not members of the *assurance team* to provide the services; and
  - ensuring the *firm* does not commit the *assurance client* to the terms of any transaction or consummate a transaction on behalf of the client.

## Fees and Pricing

## **Fees – Relative Size**

- 2.102 When the total fees generated by an *assurance client* represent a large proportion of a *firm's* total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:
- the structure of the *firm*; and
  - whether the *firm* is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- taking steps to reduce dependency on the client;
- external quality control reviews; and
- consulting a third party, such as a professional regulatory body or another professional accountant.

- 2.103 In all cases where the fees generated by an *assurance client* exceed 15% of the *firm's* total fees the following safeguards are necessary to reduce the threat to an acceptable level:
- involving an additional professional accountant who was not part of the *assurance team* to carry out reviews of the work done or otherwise as necessary;
  - provide documentation of such review to the applicable professional body, the Institute or CPA Australia, during quality review.

Where an *assurance client* provides a *firm* with an unduly large proportion of its total fees, the only course of action is to refuse to perform, or to withdraw from, the *assurance engagement*.

- 2.104 A self-interest threat may also be created when the fees generated by the *assurance client* represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
- policies and procedures to monitor and implement quality control of *assurance engagements*; and
  - involving an additional professional accountant who was not a member of the *assurance team* to review the work done or otherwise advise as necessary.

## **Fees – Overdue**

- 2.105 A self-interest threat may be created if fees due from an *assurance client* for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:
- discussing the level of outstanding fees with the audit committee, or others charged with governance; and
  - involving an additional professional accountant who did not take part in the *assurance engagement* to provide advice or review the work performed

The *firm* should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the *firm* to be re-appointed.

## **Pricing**

- 2.106 When a *firm* obtains an *assurance engagement* at a significantly lower fee level than that charged by the predecessor *firm*, or quoted by other *firms*, the self-interest threat created will not be reduced to an acceptable level unless:
- the *firm* is able to demonstrate that appropriate time and qualified staff are assigned to the task; and
  - all applicable assurance standards, guidelines and quality control procedures are being complied with.

## **Contingent Fees**

- 2.107 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this Statement, fees are not regarded as being contingent if a court or other public authority has established them.

- 2.108 A contingent fee charged by a *firm* in respect of an *assurance engagement* creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a *firm* should not enter into any fee arrangement for an *assurance engagement* under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the *assurance engagement*.
- 2.109 A contingent fee charged by a *firm* in respect of a non-assurance service provided to an *assurance client* may also create self-interest and advocacy threats. If the amount of the fee for a non-*assurance engagement* was agreed to, or contemplated, during an *assurance engagement* and was contingent on the result of that *assurance engagement*, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:
- the range of possible fee amounts;
  - the degree of variability;
  - the basis on which the fee is to be determined;
  - whether the outcome or result of the transaction is to be reviewed by an independent third party; and
  - the effect of the event or transaction on the *assurance engagement*.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- disclosing to the audit committee, or others charged with governance, the extent of nature and extent of fees charged;
  - review or determination of the final fee by an unrelated third party; or
  - quality and control policies and procedures.
- 2.110 The receipt of commissions or other benefits as a result of the *assurance engagement* poses a risk to *independence* that cannot be resolved by safeguards other than the refusal to perform the engagement.

## Gifts and Hospitality

- 2.111 Accepting gifts or hospitality from an *assurance client* may create self-interest and familiarity threats. When a *firm* or a member of the *assurance team* accepts gifts or hospitality, unless the value is clearly insignificant, the threats to *independence* cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a *firm* or a member of the *assurance team* should not accept such gifts or hospitality.

## Actual or Threatened Litigation

- 2.112 When litigation takes place, or appears likely, between the *firm* or a member of the *assurance team* and the *assurance client*, a self-interest or intimidation threat may be created. The relationship between client management and the members of the *assurance team* must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The *firm* and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the *firm* may face a self-interest threat. The significance of the threat created will depend upon such factors as:
- the materiality of the litigation;

- the nature of the *assurance engagement*; and
- whether the litigation relates to a prior *assurance engagement*.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

- disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;
- if the litigation involves a member of the *assurance team*, removing that individual from the *assurance team*; or
- involving an additional professional accountant in the *firm* who was not a member of the *assurance team* to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the *assurance engagement*.

## Appendix 3

### Conformity with International Standards on *Independence for Assurance engagements*

- 3.1 Except for the following matters, the basic principles and essential provisions of Appendices 1 and 2 of this Professional Statement and of Section 8 of the International Federation of Accountants (IFAC) Code of Ethics, are consistent in all material respects:

Paragraph 1.22 permits a *firm* to accept an *assurance engagement* where a client, being aware that the *firm* is not independent, nevertheless requests the *firm* to accept the engagement. In such instances, any report provided or opinion expressed must clearly state that their firm is not independent.

Paragraph 2.42 recognises that retired audit partners joining the boards of their audit clients has been a particular concern in Australia and requires two years to elapse following resignation from the audit *firm* before a former partner of an audit *firm* who is directly involved in the audit of a client can become a director of the client. Paragraph 2.47 extends, to ensure member certainty, the roles identified as so significant no safeguard could reduce the self-interest and self-review threats to an acceptable level, to include liquidator, provisional liquidator, controller, and scheme manager, official manager or administrator.

Paragraph 2.55 adds 'any activity barred by legislation' to those identified as activities that would create self-interest or self-review risks that only avoidance of the activity or refusal to perform the *assurance engagement* would reduce the threats to an acceptable level.

Paragraph 2.103 identifies that in all cases where a *firm's* fees generated by an *assurance client* exceed 15% of the *firm's* total fees specific safeguards are required to reduce the self-interest threat to an acceptable level and where an *assurance client* provides the *firm* with an unduly large proportion of its total fees, the *firm* is required to refuse to perform or withdraw from the *assurance engagement*.

Paragraph 2.110 recognises that the receipt of commissions or other benefits as a result of the *assurance engagement* poses a risk to *independence* that cannot be resolved by safeguards other than the refusal to perform the engagement.

- 3.2 The Statement adopts a conceptual framework for assurance engagements that requires the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level. This approach contrasts with the rules of the United States Securities and Exchange Commission (SEC) adopted in November 2000, which are prescriptive in nature and only applicable to the audits of listed entities. However the SEC rules were developed using the following four principles for measuring auditor's independence. Under these principles an accountant is not independent when the accountant:

- a. has a mutual or conflicting interest with the audit client;
- b. audits his or her own firm's work;
- c. functions as management or an employee of the audit client; or
- d. acts as an advocate for the audit client.

Although these differences in approach and scope make precise comparisons difficult the similarity of underlying philosophies ensures that in many instances the outcomes for auditing professionals determining their independence will not vary. There are however some circumstances where significant differences would result. For example, the limit imposed by the SEC on the external auditor providing no more than 40% of the total hours expended on the client's internal audit activities in any one year unless the client has less than \$200 million in total assets, contrasts to the conceptual approach which considers the nature of the internal audit services rendered.