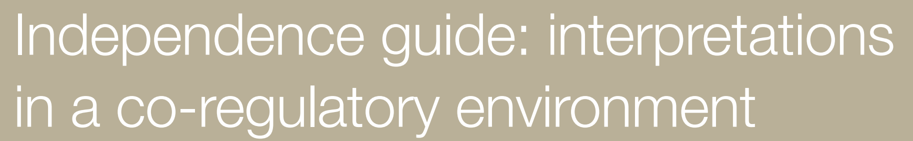
Joint Accounting Bodies

CPA Australia Ltd, The Institute of Chartered Accountants in Australia & the National Institute of Accountants



Independence guide: interpretations in a co-regulatory environment

Version 3, June 2008

The Joint Accounting Bodies

The major professional accounting bodies in Australia established the Joint Accounting Bodies to speak with a united voice to government bodies, standard setters and regulators on non-competitive matters affecting the profession. The members of the Joint Accounting Bodies are:

CPA Australia Ltd is Australia's largest professional organisation and the world's sixth largest accounting body. We have 117,000 members, including 25,000 who work in 97 countries outside Australia, and we have a significant and growing international presence through which to service them. Our office network, which spans the globe from London to Auckland, includes two offices in mainland China in Bejing and Shanghai. This year we are expanding into Vietnam, where we will have offices in Hanoi and Ho Chi Minh City. We also have several mutual recognition agreements with other professional bodies in Asia and the United States.

Our internationally respected CPA Program has been established for more than 20 years, with a major factor in its success being its anticipation of, and response to, emerging business needs. This year we're introducing a new segment, International Business. In 2007, there were close on 46,000 segment enrolments – a record number.

CPA Australia has earned a strong reputation for our leadership in areas such as taxation, corporate governance and financial reporting, as well as for tackling the skills shortage. We actively represent the interests of our members, the profession and the public, to government, regulators and standards setters.

We require the highest standards of technical competence, professional conduct and ethics from our members, so that – whether they work in the local high street or on the multinational stage – they all contribute to, and enjoy, the professional recognition, status and prestige that stems from the CPA designation. For further information about CPA Australia, visit **www.cpaaustralia.com.au**

The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 55,000 of today's and tomorrow's business leaders, representing some 44,000 Chartered Accountants and 11,000 of Australia's best accounting graduates who are currently enrolled in our world-class post-graduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 107 countries around the world. We aim to lead the profession by delivering visionary thought leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered Accountant brand. We also represent the interests of members to government, industry, academia and the general public by actively engaging our membership and local and international bodies on public policy, government legislation and regulatory issues.

The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. The GAA has a membership of 700,000 and promotes quality professional services to share information and collaborate on international accounting issues. The Institute is constituted by Royal Charter and was established in 1928. For further information about the Institute visit **charteredaccountants.com.au**

The National Institute of Accountants provides guidance and insight into long-term future planning for its 20,000 members and students in Australia and in more than 50 countries around the world, as well as quality education and career progression pathways for its members and for graduates throughout Australia.

NIA members must meet prescribed standards of education, training and experience while at the same time displaying a high standard of professional ethics. The NIA delivers the expert representation as well as the crucial technical tools and business support members require to excel in their chosen field.

The NIA also provides members with an ongoing program of professional development and education as well as a host of social and business networking opportunities and online discussion forums.

NIA members benefit from the organisation's strong alliances and leadership reaching to the international and national business sectors, State and Federal Governments in Australia as well as the public and private sectors.

Through these networks the NIA provides 'thought leadership' in addressing issues affecting the accounting profession. As a full member of the International Federation of Accountants (IFAC), the NIA is well positioned in its work with national and international standard setters to ensure members are fully represented and fully informed.

For further information about the NIA visit **www.nia.org.au**

Table of contents

1. Purpose of the guide . . . 5
1.1 Background . . . 5
1.2 Ongoing task . . . 6
1.3 International developments . . . 6

2. Application of the independence standards . . . 8
2.1 Overview . . . 8
2.2 Assurance engagements . . . 8
2.3 Identify threats . . . 8
2.4 Identify safeguards . . . 9
2.5 Objective assessment . . . 9

3. Case studies – audit engagements . . . 10
3.1 Where 'the books' of a non-listed entity are prepared by the auditor . . . 10
3.2 Where 'the books' of an SMSF are prepared by the auditor . . . 12
3.3 Auditing the accounting work of a partner . . . 13
3.4 Auditing a partner's company, trust or superannuation fund . . . 14
3.5 Where the auditor provides financial planning advice to the client . . . 14
3.6 Auditing the employer and the corporate superannuation fund . . . 15

4. Questions and answers on independence . . . 16
4.1 Financial interests . . . 16
4.2 Loans and loyalty schemes . . . 17
4.3 Ordinary course of business . . . 19
4.4 Other services . . . 20
4.5 Auditor independence declarations . . . 24
4.6 Personal appointments – power of attorney . . . 27
4.7 Contractors/employees/consultants . . . 27

5. Networks . . . 28
5.1 Network and network firms . . . 28
5.2 Network firm examples . . . 30

Table of contents contiinued overleaf >

6. Questions and answers on rotation requirements for listed clients 33
Background to the current rotation requirements for listed entities 33
6.1 Applying the five-year rotation period 35
6.2 Non-listed to listed client 37
6.3 Opting out during the last rotation period 37
6.4 Re-auditing prior periods 38
6.5 Where a partner changes firm 38
6.6 Changes in fiscal year-end 38
6.7 Audit review partner 39
6.8 Engagement quality control reviewer 39
6.9 Other roles 40
6.10 Changing from the seven- to five-year rotation periods 40
6.11 Listing on an overseas exchange 43

7. Ethical dilemmas 44
7.1 A common scenario – INTHEBLACK, May 2005 44
7.2 Testing independence – *Charter*, November 2007 46
7.3 Making the hard decisions – ***National Accountant***, Dec/Jan 2007 48

8. Appendices 52
Appendix 1. Sample inter-firm independence declaration 52
Appendix 2. Decision tree SMSFs 53
Appendix 3. Key reference material 54

Disclaimer:

Copyright May 2008 CPA Australia Ltd (ABN 64 008 392 452), the Institute of Chartered Accountants in Australia (ABN 50 084 642 571) and the National Institute of Accountants (ABN 81 004 130 643) ('joint owners'). All rights reserved. Save and except for third party content, all content in this product is owned or licensed by the joint owners. All trade marks and trade names are proprietary to the joint owners and must not be downloaded, reproduced or otherwise used without the express consent of the joint owners.

1. You may access and display pages from the website or CD-ROM on your computer, monitor or other video display device, and make one printed copy of any whole page or pages for your personal use only
2. You may download from the website or CD-ROM, and reproduce, modify, alter or adapt the provided sample inter-firm independence declaration and use them so reproduced, modified or adapted for your personal use and/or in your practice.

Other than for the purposes of and subject to the conditions prescribed under the *Copyright Act 1968* (Cwlth) (or any other applicable legislation throughout the world), or as otherwise provided for herein, no part of this product may in any manner or any medium whether now existing or created in the future (including but not limited to electronic, mechanical, microcopying, photocopying or recording), be reproduced, adapted, stored in a retrieval system or transmitted without the prior written permission of the copyright owner.

Except as expressly permitted herein, you may not (i) sublicense, lease, rent, distribute, or otherwise transfer the CD-ROM; or (ii) transmit, broadcast, make available on the internet or otherwise perform or display the CD-ROM in public, in whole or in part.

The joint owners have used reasonable care and skill in compiling the content of this product. However, the joint owners make no warranty as to the accuracy or completeness of any information in this product, and no responsibility is taken for any action(s) taken on the basis of any information contained herein, whether in whole or in part, nor for any errors or omissions in that information.

No part of this product is intended to be advice, whether legal or professional. You should not act solely on the basis of the information contained in the product as parts may be generalised and may apply differently to different people and circumstances. Further, as laws change frequently, all users are advised to undertake their own research or to seek professional advice to keep abreast of any reforms and developments in the law.

Except to the extent that the joint owners have expressly warranted in writing as to its compatibility, you shall have sole responsibility for determining the compatibility of this product with your equipment, software and products not supplied by the joint owners, and you shall have the sole responsibility for installation of any product on your systems.

The joint owners, their employees, agents and consultants exclude all liability for any loss or damage claims and expenses including but not limited to legal costs, indirect special or consequential loss or damage (including but not limited to, negligence) arising out of the information in the materials.

Where any law prohibits the exclusion of such liability, each of the joint owners limits their liability to the re-supply of the information. 0608-19

1. Purpose of the guide

This guide is intended to provide a clear indication of the conceptual approach initially adopted in Professional Statement F.1 – Professional Independence (F.1) and now addressed in Section 290 of APES 110 Code of *Ethics for Professional Accountants*, with practical examples of independence issues encountered by accountants and auditors.

1.1 Background

Following significant consultations with the Commonwealth Treasury and the Australian Securities and Investments Commission (ASIC), and ongoing member input regarding the application of the Professional Independence standards, this guide was initially published by the Institute of Chartered Accountants in Australia (the Institute) and CPA Australia in October 2005. Following admission as a member of the Joint Accounting Bodies in June 2007, the National Institute of Accountants (NIA) has co-operated with the Institute and CPA Australia to develop and publish this revised guide.

The Joint Accounting Bodies are committed to continuing this work, together with other stakeholders, to continuously re-evaluate the accounting bodies' ethical pronouncements. The bodies recognise that independence is only one piece of the jigsaw that is financial reporting, and that we cannot afford to be isolated from the world's capital markets.

The Corporate Law Economic Reform Program – Part 9 (CLERP 9) was introduced in June 2004 with independence requirements to take immediate effect. The Explanatory Memorandum to the Bill explains that the Bill looks to address the public concerns in relation to auditor independence by putting in place a broad regulatory framework governing audit oversight and independence arrangements. In doing so, the Bill retains the co-regulatory approach in relation to auditor independence. Under such an approach, the *Corporations Act 2001* contains some provisions directed at relatively specific employment and financial relationships, and the professional rules issued by the professional accounting bodies contain more comprehensive requirements.

The Ramsay Report recommendations envisaged the inclusion of a comprehensive legislative framework of auditor independence requirements in the Corporations Act, supplemented by the auditor independence rules in the professional codes of conduct.

The Institute and CPA Australia formed a task force to undertake a number of initiatives to ensure that the then F.1 was updated and enhanced to address the additional requirements of CLERP 9. As stated in the Explanatory Memorandum, CLERP 9 generally reinforces the existing professional requirements and therefore '[i]t is expected that compliance with the general requirement and declaration of independence will not give rise to any significant compliance burden in the longer term'. A number of requirements were being interpreted differently, and issues on practical implementation of the CLERP 9 Act have also arisen. Accordingly, the task force set out to provide the necessary guidance in consultation with Treasury and ASIC to ensure that the objective of consistency in application of the independence principles was achieved in practice.

Further, the Government carefully considered the area of non-audit services and concluded that the prohibition of non-audit services was not suitable for Australia. This decision was made after consideration of adopting the US Securities and Exchange Commission (SEC) approach and the conclusion reached was that 'in keeping with the principles based approach underlying CLERP 9 a disclosure-based solution … is preferred. Disclosure of the non-audit services contracted between auditors and their clients is sufficient to enable shareholders to determine whether the amount and nature of those services poses an unreasonable threat to independence while providing companies the flexibility to garner maximum benefit from the expertise gained in an audit engagement'.

The CLERP 9 approach recognises the responsibility of the auditor and the directors or audit committee where applicable to ensure that the auditor's independence is not impaired.

In the co-regulatory environment, post CLERP 9, the professional bodies established the Accounting Professional and Ethical Standards Board (APESB) to set the code of professional conduct and professional statements by which their members are required to abide, to ensure that their standards are robust and transparent and in the best interests of the public and the profession.

The APESB sets its own business plan, promulgates, reviews and oversees ethical and professional standards and consists of six members, comprising representatives from the public sector, corporate sector, audit profession, academia, and the general public. Initial appointments to the Board of Directors were Mr Stuart Black (nominee of the Institute), Professor Jack Flanagan (nominee of CPA Australia), Mr Harley McHutchison (nominee of the Institute) and Dr Kenneth Levy (nominee of CPA Australia). Mr Bob Sendt was subsequently appointed to the Board as a nominee of the NIA in December 2006, and Ms Kate Spargo was appointed as independent Chair in July 2007.

© The Australian Professional Joint Accounting Bodies

The initial appointments to the Board were made in early January 2006. The *Code of Ethics for Professional Accountants*, based on the International Federation of Accountants (IFAC) Code of Ethics and formerly contained in Professional Statement F.1, was issued on 1 July 2006 as APES 110, and has application from that date.

Following discussion with the Government, clarifying amendments were made to the Corporations Regulations in June 2006 to reflect the intent of the CLERP 9 auditor independence amendments:

- The introduction of an ordinary course of business exemption in relation to the prohibition on an audit firm owing more than $5000 to an audit client
- Clarification that cheques and savings accounts are not intended to be covered by the prohibition on loans by an audit firm to the audit client
- Giving ASIC the power to extend the period within which an auditor is required to resolve a conflict of interest situation beyond the existing 21 days under ss. 327(2A), 327(2B) and 327(2C) of the Act.

Further, the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* was passed in June 2007, and in February 2008 the APESB approved the respective amendments to APES 110. While these amendments sought to align APES 110 with the law, it also fully conforms with the IFAC Code. Accordingly, consistent with the IFAC Code, APES 110 retains the prohibition on partners in the same office as the audit partner holding a financial interest in the audit client, and is effective from 15 February 2008.

The key changes adopted are:

- Removal of the restriction on 'all partners' having financial interests in audit clients. The restriction no longer applies to partners who are not involved in the audit and not in a position to influence the outcome of the audit. However, APES 110 retains the prohibition on partners in the same office as the audit partner holding a financial interest in the audit client
- Amendment of the two-year cooling-off period for a former audit partner of the firm joining an audit client. The cooling-off period of two years will count from the date of the last audit report in which the individual was a member of the audit team instead of from the date of departure from the firm
- Introduction of a five-year limitation on the multiple former partner rule.

1.2 Ongoing task

The debate on the future of auditor independence continues both in Australia and internationally.

The co-operation of government, Treasury, ASIC, the FRC and the profession is essential to resolve and agree interpretations of independence in the co-regulatory framework of CLERP 9 in order to achieve the impact as described in the Explanatory Memorandum:

> **4.19** The legislative measures will apply a consistent and objective standard of conduct across the auditing profession and thereby promote the credibility and reliability of auditing reports and financial statements. The inclusion of an objective standard in the general auditor independence requirement is critical for enforcement purposes because objectivity, being a state of mind, is not, except in unusual circumstances, subject to direct proof. The difficulties associated with identifying a compromise of independence are also inherent in the nature of the audit process. Accordingly, the perception of auditor independence, as demonstrated by external facts and circumstances, under an objective standard takes on great importance.

> **4.22** A legislative requirement in many cases will formalise and reinforce conduct which many auditors are, or should, as a matter of best practice be complying with.

Clearly, the task of providing up-to-date, practical guidance requires the ongoing focus of all these Australian organisations and will necessarily involve the professional bodies in progressively adding to this guide.

1.3 International developments

In 2008, the International Ethics Standards Board for Accountants (IESBA) plans to issue final pronouncements on:

- Revisions to the independence requirements contained in the IFAC Code as set out in the exposure draft issued in December 2006 proposing revisions to existing Section 290 *Independence – Audit and Review Engagements* and proposing new Section 291 *Independence – Other Assurance Engagements*
- Additional revisions to independence requirements related to the provision of internal audit services to an audit client, relative size of fees from an assurance client and independence implications of contingent fees as proposed in the exposure draft issued in July 2007

© The Australian Professional Joint Accounting Bodies

- Changes to reflect the implications on the Code of the new drafting conventions adopted by the Clarity Project by the International Auditing and Assurance Standards Board.

The more significant changes resulting from the exposure draft issued in December 2006 include:

- Extending the requirements for audits of listed entities to audits of all public interest entities
- Defining public interest entities as (i) listed entities, and (ii) any entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator
- Expanding the partner rotation requirements to audits of all public interest entities to all key audit partners (this is also a new definition that includes the engagement partner, the individual responsible for the engagement quality control review and other audit partners on the engagement team who are responsible for key decisions or judgments with respect to the audit)
- Requiring partner rotation for public interest entities except in circumstances when an independent regulator has provided an exemption for firms that have only a few people with the necessary knowledge and experience to serve as a key audit partner on public interest entity audits
- Establishing a mandatory 'cooling-off' period before a key audit partner joins a former audit client that is an entity of public interest, or the individual who is the firm's senior or managing partner (chief executive or equivalent) joins such an audit client
- Non-audit services – strengthening some of the guidance on the provision of non-audit services, including:
  - **Valuation services** – providing guidance on what is meant by significant subjectivity and restricting material valuations for entities of public interest
  - **Taxation services** – providing additional guidance on taxation services

    Recognition that taxation services comprise a broad range of services including tax return preparation, preparation of tax calculations to be used as the basis for the accounting entries in the financial statements, tax planning and other advisory services and assistance in the resolution of tax disputes
  - **Information technology services** – for audit and review clients that are not public interest entities, restricting the design and implementation of financial information technology systems that are used to generate information forming part of a the client's financial statements. In the cases of audit and review clients that are public interest entities restricting services that involve either the design or implementation of such systems
  - **Corporate finance services** – expanding the guidance and aligning it to the provision of tax planning and other advisory services when the advice is dependent upon a particular accounting treatment or presentation
  - **Recruiting senior management** – for audit and review clients that are public interest entities restricting recruiting of individuals who can exert significant influence over the client's financial statements
- Partner compensation – additional guidance to recognise that compensation and evaluation policies can create a threat to independence, with restrictions on compensating and evawwluating key audit partners for selling non-assurance services to their audit clients
- Splitting existing Section 290 into two sections – proposed revised Section 290 which sets out independence requirements for audit and review engagements and proposed new Section 291 which sets out independence requirements for other assurance engagements.

The IESBA intends to complete and approve changes to the Code relating to the projects noted above, but not to release them as final documents. The IESBA will then expose proposed changes to the Code to reflect changes resulting from the drafting conventions project. After consideration of comments on the application of the drafting conventions, the Code will be issued in final form in the second half of 2008 or early 2009. It is intended that the proposed effective date will be exposed for comment.

In the interim, members are encouraged to consider the changes to the IFAC Code, in particular, the impact of extending the requirements for audits of listed entities to audits of all public interest entities; expanding the partner rotation requirements on audits of public interest entities to all key audit partners; and changes to the provision of some non-audit services.

© The Australian Professional Joint Accounting Bodies

2. Application of the independence standards

2.1 Overview

This guide is not intended to replace APES 110 in general nor Section 290 in particular but to act as guidance. It is recommended that members become familiar with the contents of APES 110 prior to reviewing their arrangements to ensure independence is maintained for assurance engagements.

Section 120 of APES 110 states that the principle of objectivity imposes an obligation on all members not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

Independence is defined as both:

- Independence of mind
- Independence of appearance.

This means that members must not only be independent in action but they must also be perceived to be independent. Paragraph 290.37 identifies the criterion of what a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. Members need to be guided not only by the specific applications identified, but also by the spirit of APES 110, and be prepared to justify, if called upon, any apparent departure from its provisions.

2.2 Assurance engagements

The independence requirements contained in Section 290 of APES 110 apply to all audit and assurance engagements. What kinds of engagements constitute assurance engagements? Paragraphs 290.2 to AUST290.7.4 refer to assurance engagements with Paras AUST290.7.1 through AUST290.7.4 being taken from the 'Framework for Assurance Engagements' and describing the nature of an assurance engagement. To obtain a full understanding of the objectives and elements of an assurance engagement you should refer to the full text of the statement 'Framework for Assurance Engagements'. This Statement was revised and reissued by the AUASB in June 2007 to reflect the introduction of the legally binding ASA auditing standards. It is now sector neutral rather than containing a separate section on the public sector perspective. Like its predecessor, the Statement is based on the IAASB's International Framework for Assurance Engagement. It provides considerable guidance on the subject of what is an assurance engagement.

The Statement defines an assurance engagement as one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The most common types of assurance engagements are those which are the subject of specific auditing standards such as reviews of financial reports (AUS 902), audit of prospective financial information (AUS 804) and performance auditing (AUS 806). (Note: These standards are all currently being revised.)

However, the absence of an auditing or assurance standard does not preclude the engagement from satisfying the definition referred to above. The crucial tests are the three party relationship, the subject matter, suitable evaluation criteria, an engagement process and a conclusion (see paragraphs 8 – 11 of the Statement) such as an investigating accountants' report.

The Statement also includes guidance on what items are not assurance engagements, that is, compilations (see APS 9), agreed upon procedures (AUS 904), and tax and management consultancy work (APS 6 and 8 respectively).

2.3 Identify threats

When determining independence, the first step is to identify the threats to independence. The threats to independence in assurance engagements are:

- **Self-interest threat** Paragraph AUST290.41.3: 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. For example, this could arise in superannuation funds where it is the member's own fund or the member provides financial advice to the fund trustees
- **Self-review threat** Paragraph AUST290.41.4: this is when:
  - Any product or judgment of a previous engagement needs to be re-evaluated in reaching conclusions on the assurance engagement, that is, the member is reviewing their own work or
  - A member of the assurance team was previously a director or officer of the assurance client or was in a position to exert direct and significant influence over the subject matter of the assurance engagement.

  An example is performing services for an assurance client that directly affect the subject matter of the assurance engagement.

© The Australian Professional Joint Accounting Bodies

- **Advocacy threat** Paragraph AUST290.41.5: this is when a firm, or member of the assurance team, promotes, or may be perceived to promote an assurance client's position to the point that objectivity may, or may be perceived to be, compromised. For example, 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** Paragraph AUST290.41.6: this is when by virtue of a close relationship with an assurance client, its directors, officers or employees, the firm or a member of the assurance team becomes too sympathetic to the client's interests,for example, when a close family member of an assurance team member is a director of the client
- **Intimidation threat** Paragraph AUST290.41.7: where a member of the team is deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client, for example, a threat of replacement over a disagreement with the application of an accounting principle.

2.4 Identify safeguards

Once the threats have been identified, the next step is to determine whether there are any safeguards that 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 firm's own systems and procedures.

Safeguards created by the profession, legislation or regulation, include the following:

- Educational, training and experience requirements for entry into the profession
- Continuing education requirements
- Professional standards, monitoring and disciplinary processes
- External review of a firm's quality control system
- Legislation covering the independence requirements of the firm
- Recommendations on independence from relevant regulators.

Safeguards within the assurance client include the following:

- Where the assurance client's management appoints the firm, persons other than management ratify or approve the appointment
- The assurance client has competent employees to make managerial decisions
- Policies and procedures that emphasise the assurance client's commitment to fair financial reporting
- Internal procedures that ensure objective choices in commissioning non-assurance engagements
- A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.

2.5 Objective assessment

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

Paragraph 290.37 requires the evaluation of threats to independence and the application of safeguards to eliminate or reduce the threats to an acceptable level. Consideration must 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. Both Section 290 and CLERP 9 require that a 'reasonable person' test be applied.

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, or to refuse to accept or continue the assurance engagement.

© The Australian Professional Joint Accounting Bodies

3. Case studies – audit engagements

A series of case studies covering some of the key aspects of the Section 290 conceptual framework for independence follow. The scenarios in the case studies are evaluated using a threats and safeguards approach and are intended to assist auditors in particular on how Section 290 should be interpreted.

Abbreviations

Para	Paragraph
s.	section
the Act	***Corporations Act 2001***

Individual circumstances should be tested against both Section 290 and the Act, and professional legal advice obtained if necessary.

These case studies should be considered in the context of Para 290.37 which provides that when the safeguards available are insufficient to eliminate the threats to independence, or to reduce them to an acceptable level, or when the 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 engagement.

Members must be independent in every assurance engagement, whether large or small.

The Institute's head of audit, Andrew Stringer, said:

> 'Some members of the accounting profession may consider certain engagements, such as self-managed superannuation funds, as small jobs where the rules concerning audit independence do not necessarily apply. While the requirements for listed entities set a higher bar, regardless of the type of engagement, preparing the accounts and then auditing them breaches professional standards and can break the law as well. There must be separation of the preparers of accounts and the auditors.
>
> It is equally important for non-audit partners to be aware of the auditor independence requirements. Otherwise, they may unwittingly impair the independence of their firm with respect to their assurance clients.'

The separation of preparers of financial statements and auditors of those statements, irrespective of the size of the task, is a fundamental tenet of professional independence.

3.1 Where 'the books' of a non-listed entity are prepared by the auditor

Scenario – your client is a non-listed entity and the books are prepared by the auditor of the entity.

The first step here is determining what is meant by 'the books are prepared by the auditor', as that phrase is often used yet can describe quite different situations where the independence threats can vary widely.

Further, independence threats and safeguards need to be evaluated separately for each audit client in relation to each audit period. For example, significant changes in the management or governance of an audit client may impact on the extent of the client's ability to take responsibility for the financial statements.

For example:

3.1.1 Where the accounting records are substantially prepared by the client and this information is provided to the auditor who only converts it to a pro-forma set of financial statements without performing accounting adjustments. The client takes responsibility for the preparation of source documents and originating data, authorising and approving transactions, determining and changing journal entries, and the classifications of accounts.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguard

Accounting records and books prepared to trial balance stage by the client and the client takes responsibility for the financial statements.

Objective assessment

Independence should not be impaired.

3.1.2 Where the accounting records are substantially prepared by the client and this information is provided to the auditor who finalises the financial statements.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

© The Australian Professional Joint Accounting Bodies

Safeguards may include:

- Obtaining client approval for any proposed journal entries or other changes affecting the financial report
- Obtaining the audit client's acknowledgment of responsibility for the results of the work performed by the firm
- Making arrangements so such services are not performed by a member of the audit team
- Making arrangements so such services are performed by a suitably qualified member of staff who does not report to a member of the audit team
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client.

Objective assessment

Independence should not be impaired.

This assumes that management is conversant with the changes being proposed and can and will still take responsibility for the final financial statements.

3.1.3 Where the client provides original documents, invoices, etc. or incomplete trial balance records, and the journal entries and general ledger records and financial statements are prepared by the auditor where:

a. The auditor is a sole practitioner or

b. The firm or authorised audit company has more than one partner.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguards

a. No safeguards can reduce the self-review threat to an acceptable level as the auditor is responsible for the preparation of the financial statements

b. Segregation of the accounting and audit roles between staff and partners, which separate the responsibility for preparation from the responsibility for review is an additional safeguard available to these firms.

Objective assessment

a. **Independence is impaired**. Where the same individual is responsible for the oversight of the preparation of the financial statements and also responsible for the audit of the financial statements, audit independence is impaired. He/she must refuse to perform, or withdraw from the audit engagement

b. Where the same partner is responsible for the oversight of the financial statements preparation and also responsible for the audit of the financial statements, audit independence is impaired. Where segregation of both the roles and responsibility for the preparation and audit of the financial statements between different staff and partners exists, audit independence should not be impaired.

3.1.4 Where the client is not a trading entity and has very few transactions, the client will often expect the auditor to record these few transactions in the books prior to preparing and auditing the financial statements. In these circumstances, each transaction and balance can be traced directly to third party records. The auditor is not required to recalculate figures or make other judgments on how balances should be derived or treated, as all balances tie directly to third party provided documents.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguard

As all balances tie directly to third party documents, the preparation of the financial statements is merely the completion of a pro-forma.

Objective assessment

Independence is not impaired when all balances tie directly to third party documents.

Note: As the number of transactions increases, the likelihood of the auditor being able to maintain independence will decrease, as judgments will increasingly need to be made and balances will no longer simply agree to third party documents.

Once the auditor makes judgments, such as assessing the value of investments, independence is likely to be impaired.

© The Australian Professional Joint Accounting Bodies

3.2 Where 'the books' of an SMSF are prepared by the auditor

Scenario – you are asked to audit and prepare the books for a self-managed superannuation fund (SMSF).

The first step here is determining what is meant by 'the books are prepared by the auditor', as that phrase is often used yet can describe quite different situations where the independence threats can vary widely.

Further independence threats and safeguards need to be evaluated separately for each audit client in relation to each audit period. For example, significant changes in the management or governance of an audit client may impact on the extent of the client's ability to take responsibility for the financial statements.

For example:

3.2.1 Where the accounting records are substantially prepared by the trustee of the SMSF and this information is provided to the auditor who uses it to complete a pro-forma set of financial statements. The trustee is knowledgeable and takes responsibility for the preparation of source documents and originating data, authorising and approving transactions, determining and changing journal entries, and the classifications of accounts.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguard

Accounting records and books prepared to trial balance stage by the trustee of the SMSF and the trustee takes responsibility for the financial statements.

Objective assessment

Independence should not be impaired.

3.2.2 Where the accounting records are substantially prepared by the trustee and this information is provided to the auditor who finalises the financial statements.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguards may include:

- Obtaining the trustee's approval for any proposed journal entries or other changes affecting the financial report
- Obtaining the trustee's acknowledgement of responsibility for the results of the work performed by the firm
- Making arrangements so such services are not performed by a member of the audit team
- Making arrangements so such services are performed by a suitably qualified member of staff who does not report to a member of the audit team
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the trustee.

Objective assessment

Independence should not be impaired.

This assumes that the trustee is conversant with the changes being proposed and can and will still take responsibility for the final financial statements.

3.2.3 Where the trustee provides original documents or incomplete trial balance records and the journal entries and general ledger records and financial statements are prepared by the auditor where:

a. The auditor is a sole practitioner

b. The firm or authorised audit company has more than one partner.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguards

a. No safeguards can reduce the self-review threat to an acceptable level as the auditor is responsible for the preparation of the financial statements

b. Segregation of the accounting and audit roles between staff and partners, which separate the responsibility for preparation from the responsibility for review, is an additional safeguard available to these firms.

© The Australian Professional Joint Accounting Bodies

Objective assessment

a. **Independence is impaired.** Where the same individual is responsible for the oversight of the preparation of the financial statements and also responsible for the audit of the financial statements, audit independence is impaired. He/she must refuse to perform, or withdraw from the audit engagement

b. Where the same partner is responsible for the oversight of the financial statements preparation and also responsible for the audit of the financial statements, audit **independence is impaired**.

Where segregation of both the roles and responsibility for the preparation and audit of the financial statements between different staff and partners exists, audit **independence should not be impaired**.

3.2.4 Where the superannuation fund has very few transactions, the trustee of the SMSF often expects the auditor to record these few transactions in the books prior to preparing and auditing the financial statements. In these circumstances, each transaction and balance can be traced directly to third party records. The auditor is not required to recalculate figures or make any judgments on how balances should be derived or treated, as all balances tie directly to third party provided documents.

Threat

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Safeguard

As all balances tie directly to third party documents, the preparation of the financial statements is merely the completion of a pro-forma.

Objective assessment

Independence is not impaired when all balances tie directly to third party documents.

Note: As the number of transactions increases, the likelihood of the auditor being able to maintain independence will decrease, as judgments will increasingly need to be made and balances will no longer simply agree to third party documents.

Once the auditor makes judgments, such as assessing the value of investments, **independence is likely to be impaired**.

Refer to:

- Section 8 Appendix 2 of this guide, for a decision tree for SMSF auditors to identify threats to independence
- The websites of the Joint Accounting Bodies for their publication ***Competency Requirements For Auditors of Self-Managed Superannuation Funds***, published February 2008.

3.3 Auditing the accounting work of a partner

Scenario – you are asked to audit the accounting work of another partner of your firm for a non-listed client.

Again, the first step is determining what is meant by 'auditing the accounting work of another partner', as that phrase is often used yet can describe quite different situations where the independence threats can vary widely.

For example:

3.3.1 Where the tax return is prepared by staff. The resulting pro-forma financial statements are then audited by a partner in the firm.

Threats

Self-review threat – this arises where the auditor is reviewing their own work or is responsible for the work of the preparer.

Advocacy threat – this can arise where one arm of the firm is making decisions in relation to the preparation of the financial statements, for example, making decisions with respect to particular tax treatments for clients.

Safeguard

Segregation of roles between staff members and partners, which separates both the duties and the responsibility for preparation of the financial statements from the duties and responsibility for review.

Objective assessment

Where segregation of both the actual roles and responsibility for the preparation and audit of financial statements exists audit **independence should not be impaired**.

© The Australian Professional Joint Accounting Bodies

Note: Independence cannot be achieved where the partner responsible for the oversight of the financial statement preparation is also responsible for the oversight of the audit of the financial statements. Where a sole practitioner, or the same partner, is responsible for both the preparation and audit of the financial statements, audit **independence is impaired**.

3.3.2 When one arm of the firm reporting to one partner is responsible for the preparation of the financial statements, and another partner is responsible for the audit of those statements.

Threat

Self-review threat – this arises where the staff preparing the financial statements also report to the partner responsible for the audit.

Safeguards

- Obtaining the client's acknowledgment of their responsibility for the financial reporting framework adopted, the appropriate presentation and approval of the financial statements
- Making arrangements so such services are not performed by a member of the audit team
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the client.

Objective assessment

Where segregation of both the actual roles and responsibility for the preparation and audit of financial statements exists, audit **independence should not be impaired**.

Note: Where the firm is involved in making decisions on behalf of the client, then audit **independence is impaired**. Such decisions may include, but are not limited to, choosing depreciation rates and methods, determining the level of bad debts, and assessing the value of investments.

3.4 Auditing a partner's company, trust or superannuation fund

Scenario – you are asked to audit a company/ trust and/or superannuation fund where your partner is a director and/or shareholder, trustee and/or beneficiary, or member.

Threat

Familiarity threat – this arises as the audit team has an association with an individual responsible for the governance of the client and/or a financial interest in the client.

Safeguards

- Applying standard processes to the audit of the entity
- Involving an additional professional accountant from outside the firm to review the work done or otherwise advise as necessary.

Objective assessment

It is unlikely that safeguards can be put in place to overcome the familiarity threat. As such, **independence cannot be achieved**, and you must refuse to perform the engagement.

3.5 Where the auditor provides financial planning advice to the client

Scenario – you are asked to audit an existing client where financial planning advice has been provided by your firm.

Threats

Self-review threat – the auditor could be in a position of auditing the investments their firm has arranged to be made.

Self-interest threat – the auditor could be in the position of ensuring investments their firm has recommended are valued appropriately and still exist. This will be a greater threat where the advisor's remuneration is linked to funds under management.

Safeguard

Internal processes requiring the use of externally produced information such as broker and fund manager reports to value assets and the payment of remuneration by a third party such as a fund manager will reduce the threat.

© The Australian Professional Joint Accounting Bodies

Objective assessment

Audit independence cannot be achieved where you or your firm arranges the client's investments directly, that is, moneys are paid to you or your firm prior to remittance to the investment provider. You must refuse to perform the audit engagement.

Audit independence cannot be achieved where asset valuation is not obtained independently, that is, you or your firm prepares valuation reports. You must refuse to perform the audit engagement.

3.6 Auditing the employer and the corporate superannuation fund

Scenario – you are asked to audit the corporate superannuation fund of an employer, which is also one of your audit clients.

Key issue

Who appoints the auditor?

Threat

Self-interest threat – the auditor could be in a position of being appointed by the employer sponsor and a perceived threat exists in that the superannuation fund members believe the existing relationship with the employer may influence the auditor of the corporate superannuation fund.

Safeguards

The auditor should ensure that the appointment is made by the trustees of the superannuation fund.

Objective assessment

Independence cannot be achieved where the employer sponsor appoints the auditor directly.

To ensure independence is not impaired the appointment of the auditor should be made on an arms length basis as an independent arrangement between the trustee and the auditor. The minutes of the trustee should reflect the appointment of the auditor and the acceptance of the decision by the trustee board.

© The Australian Professional Joint Accounting Bodies

4. Questions and answers on independence

Following is a series of questions and answers addressing issues posed by members since F.1 was issued and CLERP 9 implemented. These questions are intended to assist auditors in how both the statement and legislation should be interpreted.

Abbreviations

Para	Paragraph
s.	section
the Act	*Corporations Act 2001*

Individual circumstances should be tested against Section 290 and the Act, and professional legal advice obtained if necessary.

These questions and answers should be considered in the context of Para 290.37 which provides that when the safeguards available are insufficient to eliminate the threats to independence, or to reduce them to an acceptable level, or when the 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.

4.1 Financial interests

When evaluating the significance of the self-interest threat created by a financial interest in an assurance client there are three key issues:

- The role of the person holding the financial interest
- The materiality of the financial interest
- The type of financial interest (direct or indirect).

Direct financial interests are either those owned directly by and under the control of the individual or entity (and include those managed on a discretionary basis by others), or beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has control.

Indirect financial interests are beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.

The key distinction between direct and indirect interests is whether the individual or entity has control.

Q4.1.1 What if my firm has a superannuation fund with a financial interest in an audit client?

Answer First, this question needs to be considered in the Australian context where employer-sponsored superannuation funds operate within the following legislative framework (SIS):

- A minimum level of superannuation contributions by employers is required, that is, Australian employers do not have discretion as to whether they wish to provide superannuation
- The trustee of a corporate superannuation fund must comprise 50 per cent of employer appointed directors and 50 percent of member-appointed/elected directors. All decisions of the trustee must be made by no less than two-thirds of directors. The employer has limited power of appointment and removal of the Trustee and does not appoint the fund's management
- The trustee has power over the operations of the fund including:
  - Determination of investment strategy
  - Appointment of investment managers
  - Appointment of custodian
  - Appointment of administrator
  - Appointment of actuary
  - Appointment of auditor
- The employer is prohibited by law from directing the operations of the fund
- The ultimate responsibility for actions taken by the Fund rests with the individual trustee directors. Legislation provides for the grant of financial assistance to members where loss has occurred as a result of fraudulent conduct or theft. This financial assistance is provided by a levy on other superannuation funds.

Paragraph 290.116 provides:

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.

© The Australian Professional Joint Accounting Bodies

In addition to these legislative safeguards, where a trustee out-sources the fund administration and management of the investments to third parties (non-audit clients), and investments in the firm itself or its related entities are prohibited, these additional safeguards are recognised as reducing the self-interest threat to an acceptable level.

In relation to the self-interest threat of the employees' interest in the superannuation fund, it is also recognised that limiting employees to choosing different investment options, without the choice of underlying investments, is an acceptable safeguard applied to reduce the self-interest threat to an acceptable level.

However, these issues may necessitate limits being placed on the choice of funds available to employees to ensure that such threats to independence are kept to an acceptable level. For example, it may be appropriate to limit employees' choice of public offer funds where members may take an active role in investment options.

Q4.1.2 What about industry funds?

Answer As the SIS legislation also applies to industry funds, such as the accountants' fund, the same safeguards will generally reduce the threats to an acceptable level for such funds.

Q4.1.3 Where do SMSF entitlements fit, are they direct or indirect financial interests?

Answer Generally such funds would be treated as the individual's direct financial interests as they are operated under the individual's control, particularly in relation to the fund's investments. Accordingly the firm's quality control policies and procedures should address whether such SMSFs of partners, members of the audit team, managerial employees who provide non-assurance services to the audit client or their immediate families hold investments in an audit client. Once recognised, such financial interests need to be considered with reference to the specific provisions of Section 290, applicable to audit clients, Paras 290.113 to 290.125.

In addition, the Act's prohibitions on assets that are investments in an audited body and beneficial interests in an audited body should also be considered.

4.2 Loans and loyalty schemes

Accounts with a financial institution

Q4.2.1 I work at an audit firm and I have been asked to be a member of the team which provides audit services to a local bank. I have an account with the bank. Can I do this without impairing the independence of the audit?

Answer Section 290 requires all professional members of the audit team to consider relationships and financial interests with the audit client that may impair independence. Savings and cheque accounts may give rise to a conflict of interest situation when the balance represents a material component of a person's net wealth or where it is by its nature an investment. However, in most instances savings and cheque accounts are merely facilities which allow individuals to receive salary and wages and to process day-to-day personal financial transactions, and do not give rise to an independence issue.

Item 16 of the table of *Relevant relationships* in s. 324CH(1) of the Act, read in conjunction with the table of *People and entities covered* in s. 324CF(5), prohibits a professional member of the audit team conducting the audit of the audited body from being owed an amount under a loan by an audit client or a related body corporate of the audit client. Note that the immediate family members of the professional member of the audit team may be owed money under a loan by an audit client as long as it is in the ordinary course of business.

While amounts owing by a bank under a cheque or savings account may not be regarded as a loan in a commercial sense, the common law interpretation of a loan includes deposit accounts held with a bank. This presented a considerable burden for auditors of banks and other financial institutions that offer cheque and savings account facilities to their customers as it involved the closing of all firm and audit team members' accounts with the banks. Accordingly, the Corporations Amendment Regulations 2006 (No. 4) clarified that cheques and savings accounts can now be disregarded under s. 324CH (6) and (6A).

© The Australian Professional Joint Accounting Bodies

Q4.2.2 I've recently joined a firm that audits the financial institution that has the mortgage over my home, and I'm thinking of drawing down additional funds as part of a personal refinancing for extensions and an overseas trip. As I'm the audit manager for that client, are there independence issues that I should consider?

Answer Yes, Section 290 recognises the threat to independence of loans from assurance clients – see Para 290.104ff. Your mortgage should be disclosed to your audit partner.

Specifically, Para 290.127 provides an exception for members of the audit team and their immediate family where such loans are made under normal lending procedures, terms and requirements. So your current housing loan and the refinancing is not regarded as impairing your independence, if made under normal terms.

Q4.2.3 I am a partner in a firm and have a housing loan with a bank which is an audit client of my firm. I am not involved in the conduct of the audit and do not provide any other professional services to the bank. When I first purchased my home, I took out this loan to an amount of $500,000. I then undertook some extensive renovations to the home and increased the mortgage by another $250,000 for the sole purpose of the renovations.

Section 324CH(5) of the Act permits such loans but only to pay the whole or part of the purchase price of premises that are used as a principal place of residence. Does the additional mortgage in relation to the renovations give rise to an independence issue for the firm?

Answer Item 15 of the table of *Relevant relationships* in s. 324CH(1) of the Act disregards housing loans under s. 324CH(5) if they are for the purchase price of premises used as a principal place of residence. Section 324CH(5)(B) disregards the increase in the mortgage as on normal terms and conditions, and the goods and services are for the personal use of the partner.

Paragraphs 290.127 and 290.131 recognise that a loan from an audit client that is a financial institution to a member of the audit 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.

Q4.2.4 I am a partner at an audit firm and I have an interest in a body corporate which is considering taking out a loan with a bank that is an audit client of our firm. I have no influence on the management of the body corporate and their decision in relation to the bank from which they obtained the loan. I do not provide any professional services to the bank. Will the firm's independence in respect of the audit client be impaired if the loan relationship is entered into?

Answer Section 290 prohibits loans from audit clients that may give rise to a self-interest threat. Generally, for such a threat to arise, the person involved must be aware of the 'interest' and take this into account when undertaking their responsibilities as a member of the audit team or a member of the firm. Item 15 of the table of *Relevant relationships* in s. 324CH(1) of the Act, read in conjunction with the table of *People and entities* covered in s. 324CF(5), prohibits (a) a partner of an audit firm or (b) an entity that the partner controls or (c) a body corporate in which the partner has a substantial holding from owing an amount of more than $5000 to an audit client of the firm or a related body corporate of the audit client.

The prohibition does not apply where the debt is on normal terms and conditions, and arises from the acquisition of goods and services on normal trading terms from the audited body.

Q4.2.5 I recently purchased a number of household goods in excess of $5000 from ABC, but, instead of paying cash, I decided to accept the store's offer to pay for the goods in 12 months' time. I have recently become aware that the store used a finance company and that I have entered into an interest-free loan (on normal terms and conditions). The loan is not with ABC but finance company XYZ. I am a member of the audit firm that audits XYZ. Does this give rise to an independence issue?

Answer Independence would be impaired according to s. 324CH(1) – table item #15, except for the ordinary course of business exception under s. 324CH(5A)(b). The exception disregards a debt owed by a person or firm from the audit client where the goods and services will be used by the person or firm for their personal use or in the ordinary course of business of the person or firm.

Even though the original purchase was with a non-audit client, the underlying loan is with an audit client. As this is a common arrangement, members of audit firms will need to ensure that they disclose such arrangements where any loans are entered into with department stores where the loan is externally financed by an audit client of the firm.

© The Australian Professional Joint Accounting Bodies

Loyalty schemes

Q4.2.6 I am the audit manager for an audit client which offers a loyalty scheme involving membership rewards and 'frequent flyer' points offering retail and travel benefits. I am a member of this loyalty scheme. Can I continue to be a member of such a loyalty scheme offered by the audit client and continue to accrue and redeem points and rewards without impairing my independence?

Answer Yes. Any points you have or are accruing to you under such a loyalty scheme would generally not be considered to be 'an amount owed' by the audit client to you under a loan as prohibited under item 16 of the s. 324CH (1) table of *Relevant relationships*.

The Act does not define the word 'loan' for the purposes of s. 324. However, in the context of item 16, it is reasonable to interpret 'loan' as involving moneys owing, owed or payable. Loans usually involve a promise by one person (lender) to pay a sum or sums of money to another (borrower) in consideration of the borrower agreeing to repay that sum of money on demand or at a fixed future date or dates.

Under the terms of most retail or frequent flyer reward or loyalty schemes no moneys are usually owed or payable – only points are accrued, and those points are not generally redeemable for money (as opposed to retail store vouchers). Under such arrangements, there is also usually no promise to pay a sum or sums of money nor agreement for repayment of money.

4.3 Ordinary course of business

Trading with an audit client

Q4.3.1 My audit firm trades on normal terms and conditions with an audit client. The trading terms include payment terms of 30 days, and this is consistent with terms for other customers. There is not another supplier available to my firm. If the balance on account at any time is greater than $5000 would this give rise to an independence issue?

Answer There are many instances where these circumstances arise such as tenancy agreements, airlines, charge cards, telecommunications and software providers that operate in industries with limited competition. This is also not unusual in regional areas where availability of auditors and commercial suppliers is limited.

The intention of the restrictions under the general principle of independence as described in Section 290 is to ensure that financial interests between audit firms, partners and related entities do not impair the exercise of impartial judgment. Therefore, normal commercial trading within reasonable business limits and on terms and conditions that are consistent with other customers would not in themselves give rise to a conflict of interest. However, if the firm was to go outside of those terms, a conflict of interest might arise.

Section 290 also requires the auditor to consider the familiarity threat and put safeguards in place to ensure independence is not impaired. In order to address the familiarity threat, the audit partner and members of the audit team should not have any involvement in the procurement of goods and services from the client.

While table item #15 of s. 324CH(1) applies to the firm and provides that an amount owed to the audit client must not exceed $5000, the Corporations Amendment Regulations 2006 (No. 4) introduced an ordinary course of business exemption in relation to this prohibition. Accordingly, if the account at any time was greater than $5000 an independence issue does not arise if such account was otherwise maintained in the ordinary course of business as it is disregarded under s. 324CH(5A).

© The Australian Professional Joint Accounting Bodies

Insurance arrangements

Q4.3.2 I am the audit manager on the audit of XYZ insurance company, an audit client of the firm. I have motor vehicle insurance with XYZ insurance company and have recently been involved in a traffic accident. I have referred the matter to, and made a claim on, my insurance with XYZ insurance company. I am waiting for my claim to be processed and resolved. I have been told that it could take a month to finalise, and XYZ insurance company seems to be holding back on the claim. Are there any independence issues?

Answer Insurance arrangements with audited bodies are not prohibited 'relevant relationships' under s. 324CH(1). Further, the amount owed to you by the insurance company arising from the claim would not constitute a loan and therefore would not be prohibited under item 18 of the table.

You should be careful to ensure that your dealings with XYZ insurance company are not, or could not be, construed as a conflict of interest situation under the general test of auditor independence. Such circumstances may arise where you are in dispute with XYZ insurance company on a claim.

If dealings between you and XYZ insurance company on your claim are such that:

- You, or it could be construed that you, as a member of the audit team of XYZ insurance company, are not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body or
- A reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that you are not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body

then you should discuss the matter with your audit partner and consider whether you:

- Are able to continue on the audit giving consideration to any safeguards that may be appropriate or
- Should remove yourself from the audit.

4.4 Other services

Q4.4.1 Some accounting firms have developed their own proprietary income tax preparation software. The software is used to facilitate the preparation of company income tax returns for various tax jurisdictions. Can an accounting firm license or sell its proprietary income tax preparation software to an audit client?

Answer While it is necessary to evaluate the significance of any threat created by the provision of assurance and non-assurance services to the same client, the provision of taxation services to an audit client is not generally seen to create threats to independence (Para 290.180 Provision of Taxation Services to Audit Clients). Accordingly, it would be permissible for the firm to license or sell its income tax preparation software to an audit client, so long as the functionality is, indeed, limited to the preparation of returns for filing of tax returns. If the software performs additional functions, each function should be evaluated for its potential effect on the auditor's independence. For example, refer to the following question for a discussion regarding the potential threat to independence of the provision of tax effect accounting software.

Q4.4.2 My listed audit client has requested assistance in applying AASB 112 – Income Taxes and I am concerned about the potential threat to independence.

What can my audit team and the firm's tax division do to assist the client?

Answer Paragraph 290.168 allows audit and accounting firms to provide technical advice on complying with accounting standards to their audit clients without it being considered a threat to their independence. This is on the basis that this kind of work is an integral part of the audit process in order to ensure the fair presentation of the annual report.

However, the extent of the work required to assist the client will need to be assessed on a case-by-case basis to ensure it does not become a situation of the auditor reviewing his or her own work. This is because Section 290 assumes that management is conversant with the changes being proposed and can and will still take responsibility for the final financial statement.

Further guidance on what constitutes acceptable 'accounting work' for clients is contained in Paras 290.170 to 290.173. Note that the requirements are more stringent for listed entities than they are for unlisted entities.

© The Australian Professional Joint Accounting Bodies

If the client's only knowledge of tax effect accounting issues comes from its auditors, then their effective exercise of this responsibility over the financial statements will prove difficult.

Accordingly, within the context of Section 290, the auditor may advise audit clients on the accounting principles involved and may provide examples of the formal journal entries required. However, the actual journal entries must not be prepared by the audit team, or any other professional staff members within the firm providing non-audit services to the client.

The auditor may then propose adjusting journal entries for the audit client's consideration.

Section 290 permits the firm to provide taxation services to an audit client, as such services (including tax compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes – Para 290.180, Provision of Taxation Services to Audit Clients) are generally not seen to create threats to independence. However, this permitted scope of services does not extend to the calculation, determination, or preparation of the tax effect accounting journal entries.

However, the audit client may also request the assistance of the firm in providing software to generate such information, which as it then forms part of the client's financial report may create a self-review threat (Paras 290.187 to 290.191 Provision of IT Systems Services to Audit Clients). Such self-review threat is likely to be too significant unless appropriate safeguards are put in place, such as:

- The audit client acknowledges its responsibility
- The audit client accepts responsibility by designating a competent employee with responsibility for the meaningful review of the output
- Such software is available to a broad market, and not specifically tailored by the firm for the audit client.

An appropriately worded and discussed letter of engagement setting out the scope of work between the client and the auditor would help clarify these issues.

Accordingly, while the firm may provide such discrete tax effect accounting software and the audit team may subsequently review the suitability of the software applied without creating a self-review risk, the audit client must apply the software, accept responsibility for the choice of software, the assumptions and inputs, and the results of the software in determining the tax effect accounting journal entries.

Q4.4.3 My listed audit client has requested my assistance in the valuing of options granted to directors and officers and I am concerned about the potential threat to independence.

What can my audit team and the firm's specialist valuers do to assist the client?

Answer Section 290 recognises that a self-review threat may be created when a firm or network firm performs a valuation for an audit client that is incorporated into the client's financial statement. Accordingly, if the valuation service involves the valuation of matters material to the financial report and the valuation involves a significant degree of subjectivity, such valuation services should not be provided or, alternatively, you would need to withdraw from the audit engagement (Paras 290.175, 290.176).

The first step is to determine whether the audit firm can value the options, that is, are they material to the financial report?

Answer When considering materiality from an independence perspective, it encompasses both quantitative and qualitative factors, including the significance of the relationship between the auditor and the directors and officers of the audit client.

The firm should not prepare a valuation in respect of options granted to directors and officers.

Further, the extent of any work required to assist the client will need to be assessed on a case-by-case basis to ensure it does not become a situation of the auditor reviewing his or her own work. This is because Section 290 assumes that management is conversant with the requirements of the accounting standards and can and will still take responsibility for the final financial statements.

Further guidance on what constitutes acceptable 'accounting work' for clients is contained in Paras 290.170 to 290.173. Note that the requirements are more stringent for listed entities than they are for unlisted entities.

If the client's only knowledge of the valuing of options granted to directors and officers comes from its auditors, then their effective exercise of this responsibility over the financial statements will prove difficult.

© The Australian Professional Joint Accounting Bodies

Accordingly, within the context of Section 290, the auditor may advise audit clients on the accounting principles involved and may provide examples of the formal journal entries required. However, the originating journal entries must not be prepared by the audit team, or any other professional staff members within the firm providing non-audit services to the client.

The auditor may then propose adjustments for the audit client's consideration.

However, the audit client may also request the assistance of the firm in providing software to generate such information, which as it then forms part of the client's financial report may create a self-review threat (Paras 290.187 to 290.191 Provision of IT Systems Services to Audit Clients).

An appropriately worded and discussed letter of engagement setting out the scope of work between the client and the auditor would help clarify these issues.

The firm may provide option valuation models and the audit team may subsequently review the suitability of the model applied without creating a self-review risk, but the audit client must apply the model, accept responsibility for the model selection, the assumptions and inputs, and the results of the model, that is, the valuation.

Q4.4.4 I am concerned about the possible independence issues that might arise when I advise my audit client concerning changes to their financial statements to comply with any new reporting requirements and then perform the audit work on the statements. What guidance is available to assist me in working through these issues?

Answer Para 290.168 allows audit and accounting firms to provide this kind of advice to their audit clients without it being considered a threat to their independence. This is on the basis that this kind of work is an integral part of the audit process in order to ensure the fair presentation of the annual report.

However, the extent of the work required to assist the client will need to be assessed on a case by case basis to ensure it does not become a situation of the auditor reviewing his or her own work. This is because Section 290 assumes that management is conversant with the changes being proposed and can and will still take responsibility for the final financial statement.

If the client's only knowledge of the issues comes from its auditors, then their effective exercise of this responsibility may prove difficult. This will necessitate both the auditor and client needing to address how best to resolve the independence issue arising. Further guidance on what constitutes acceptable 'accounting work' for clients is contained in Paras 290.170 to 290.173. Note that the requirements are more stringent for listed entities than they are for unlisted ones.

An appropriately worded and discussed letter of engagement setting out the scope of work between the client and the auditor would help clarify these issues.

Q4.4.5 I am the auditor of a small listed company currently in the process of implementation of IFRS. Do Section 290 and the Corporations Act recognise the auditor's role in conversion to IFRS?

Answer Section 290, and indirectly the Corporations Act, adopts a principles-based approach to the provision of non-audit services to audit clients. This approach requires the auditor to carefully consider the provision of services to audit clients that would give rise to a conflict of interest situation or create a significant threat to independence. The Act defines a conflict of interest situation to be any situation that would lead to, or a reasonable person with full knowledge of the facts would believe would lead to, the auditor not being capable of exercising objective and impartial judgment in relation to the conduct of the audit.

Guidance on the application of the general principles of independence is provided in Section 290, which states:

> **290.168** The audit process involves extensive dialogue between the [audit] Firm and management of the Audit Client. During this process, management requests and receives significant input regarding such matters as accounting principles and Financial Statement 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 Statements. 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, analysing and accumulating information for regulatory reporting, assisting in the preparation of consolidated Financial Statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting 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.

© The Australian Professional Joint Accounting Bodies

Q4.4.6 Is there any real difference between providing technical advice to clients and determining the impact of that advice and developing the solution?

Answer There is a fundamental difference between providing technical advice and providing a solution based on the technical advice. That difference is that the second situation effectively gives rise to making a management decision. The auditor cannot act in the role of client management and maintain independence. Further, the auditor cannot manage the project for the client or make any decisions in relation to the implementation of IFRS. However, the auditor has a fundamental role to play in discussions with the client on the application and interpretation of IFRS in the financial report.

Q4.4.7 What is the difference between providing technical accounting advice and acting in the role of management?

Answer It is the responsibility of a company's management to select and apply its accounting policies, though the company may request the auditor's advice regarding their selection of accounting policies and whether such a selection is consistent with the requirements of IFRS. However, client management must be conversant enough with the accounting issues to be able to effectively exercise responsibility for its decisions. If the client's only knowledge of IFRS issues comes from its auditors, then a self-review threat may arise from the company's reliance on the auditor's advice.

Q4.4.8 In relation to the implementation of IFRS, what services can my firm provide to audit clients while maintaining our independence?

Answer Description of service

Service	
Project management	**No**
Advice and consultation to client on implementation	**Yes**
Perform gap analysis of data requirements required to comply with IFRS	**Yes**
Provide options for management consideration	**Yes**
Identify system and process changes required	**No**
Advise management on system and process	**Yes** alternatives available
Provide technical advice to the client on interpretation and application of IFRS including identification of options	**Yes**
Make decisions on accounting policies, procedures to be adopted or implementation techniques	**No**
Make observations and recommendations on client-drafted materials	**Yes**
Implement revised systems and procedures	**No**
Adapt and complete new IFRS reporting packages and new IFRS consolidation	**No**
Assist in identification of training needs for decision by management	**Yes**
Develop and conduct accounting technical training	**Yes**
Train client staff in client processes and interpretations	**No**

© The Australian Professional Joint Accounting Bodies

Non-audit services provider/10 hours' test

Q4.4.9 I am a partner in the tax division and have been asked to assist an audit client of the firm with a complex issue relating to tax. The non-audit service does not impair independence. The engagement is expected to require more than 10 hours. My wife works for the audit client and while she is not an officer of the audit client or in an audit critical role she receives share options as part of a staff bonus scheme. The bonus scheme restricts the ability to exercise the options until such time as certain other events occur. One such requirement is a minimum service requirement. We have always sold shares arising from the bonus scheme as soon as control over the exercise of the options has passed to her. As a non-audit service provider will the existence of the scheme and the unvested options require me to decline the work due to independence issues?

Answer The existence of the bonus scheme and unvested options is unlikely to impair independence of the auditor or the firm under the general independence standards of Section 290. However, you must consider the requirements of s. 324CH(1) item 10. Note that this restriction does not apply to immediate family members of partners of the firm but will apply if you accept the role as non-audit service provider. Therefore, you will not be able to provide non-audit services to the audit client. You may apply to ASIC for an exemption outlining the circumstances of the options, your spouse's role with the client, and the nature of the service to be provided under ASIC's specific exemption provisions in s. 341 of the Act.

4.5 Auditor independence declarations

Q4.5.1 What entities are required to provide an 'auditor independence declaration'?

Answer Where an entity is required to prepare a financial report in accordance with Chapter 2M of the Corporations Act then an 'auditor Independence declaration' is required by s. 307C.

Entities required to report under Chapter 2M are:

- Disclosing entity
- Public company
- Large proprietary company
- Registered schemes
- Small proprietary company when shareholders direct the company to provide an audited financial report
- Small proprietary company directed to provide an audited financial report by ASIC.

Note: For an example of a declaration, refer to the Section 290 Appendix.

Q4.5.2 When is an auditor required to provide a written independence declaration?

Answer Auditors have both professional and legal obligations to communicate in writing regarding their independence and are required to comply with both the spirit and letter of the law. While similar, the specific requirements of the professional standards and the law do differ in detail.

The Code of Ethics APES 110 adopts a conceptual framework that requires the identification and evaluation of threats to independence and, where possible, the application of safeguards to eliminate or reduce any threats created to an acceptable level.

© The Australian Professional Joint Accounting Bodies

The Corporations Act itself includes both a general independence requirement and also specific independence requirements concerning financial and other relationships. The general requirement concerns conflict of interest situations where:

- The auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body or
- A reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.

There can be circumstances that contravene the independence requirements of the Act itself that do not contravene the requirements of APES 110. Conversely, there can be circumstances that contravene the requirements of APES 110 that do not contravene the requirements of the Act.

In summary then:

- The relevant provisions of the Code of Ethics APES 110 Section 290 Independence – Assurance Engagements provides that:

> **290.43** Firms should establish policies and procedures relating to Independence communications with audit committees, or others charged with governance of the Client. In the case of Listed Entities, disclosing entities and registered schemes the Firm should communicate orally and in writing, for each financial and half year report, 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 section and must include a written statement that, to the best of the knowledge and belief of the Lead Engagement Partner there have been no contraventions of the Independence requirements of this Code.

- *Corporations Act 2001* s. 307C(1) provides:

> If an individual auditor conducts:
>
> a. an audit of the financial report for a financial year; or
>
> b. an audit or review of the financial report for a half-year;
>
> the individual auditor must give the directors of the company, registered scheme or disclosing entity:
>
> c. a written declaration that, to the best of the individual auditor's knowledge and belief, there have been:
>
>   i. no contraventions of the auditor independence requirements of this Act in relation to the audit or review; and
>
>   ii. no contraventions of any applicable code of professional conduct in relation to the audit or review; or
>
> d. a written declaration that, to the best of the individual auditor's knowledge and belief, the only contraventions of:
>
>   i. The auditor independence requirements of this Act in relation to the audit or review; or
>
>   ii. any applicable code of professional conduct in relation to the audit or review;
>
> are those contraventions details of which are set out in the declaration.

Where an entity is required to prepare a financial report in accordance with Chapter 2M of the Corporations Act, then an 'auditor independence declaration' is required by s. 307C. Entities required to report under Chapter 2M are:

- Disclosing entity
- Public company
- Large proprietary company
- Registered scheme
- Small proprietary company where shareholders direct the company to provide an audited financial report under s. 293
- Small proprietary company directed to provide an audited financial report by ASIC under s. 294
- Small proprietary company under foreign company control that prepares a financial report under s.292(2)(b).

In summary then, to determine whether an Independence Declaration is mandatory consider both of the following questions in the table overleaf for each type of audit client for annual and half-year audits and reviews (where applicable).

Where there is no requirement to provide an independence declaration, to do so would represent best practice.

© The Australian Professional Joint Accounting Bodies

	Chapter 2M							Other	
Is an independence declaration under s. 307C required for an audited financial report of a …	**disclosing entity** where the financial report is required under Chapter 2M? Yes	**public company** where the financial report is required under Chapter 2M? Yes	**large proprietary company** where the financial report is required under Chapter 2M? Yes	**registered scheme** where the financial report is required under Chapter 2M? Yes	**small proprietary company** where the financial report is required under Chapter 2M pursuant to a direction by shareholders? Yes	**small proprietary company** where the financial report is required under Chapter 2M pursuant to an ASIC direction? Yes	**small proprietary company** under foreign company control that prepares a financial report under s. 292(2)(b)? Yes	**financial services licensee** where the financial report is required under Chapter 7? *No, unless the licensee is also required to prepare the financial report under Chapter 2M.*	**superannuation fund?** *No, as superannuation funds prepare accounts in accordance with the SIS Act and Financial Services (Collection of Data) Act.*
Is written communication with an audit client required under APES 110 Para. 290.43 for an audited financial report of a …	**disclosing entity?**[1] Yes. This communication may be included in the independence declaration under s. 307C, but it may be necessary to include additional information to that required by the Act itself.	2	2	**registered scheme?** Yes. This communication may be included in the form of an independence declaration under s. 307C, but it may be necessary to include additional information to that required by the Act itself.	2	2	2	2	2

Refer to APES 110 Section 290 Appendix for a pro-forma independence declaration.

1. A disclosing entity includes a listed entity (s. 111AE).
2. APES 110 Para 290.43 only requires written communication for listed entities, disclosing entities and registered schemes.

© The Australian Professional Joint Accounting Bodies

4.6 Personal appointments – power of attorney

Q4.6.1 I am a partner in a large audit firm with many listed entities as audit clients. My mother has asked me to be executor of her will and has given me power of attorney. My immediate family and I are likely to be the beneficiaries of the estate. While not aware of specific shareholdings, I am aware that she does have a number of direct shareholdings. I was executor of my father's will wherein my mother was the sole beneficiary and recall that probate took some six weeks to finalise. In the event of my mother's death, what is the impact of the beneficial holding of shares during the period of probate on the firm's independence with audit clients. Should I refuse to be the executor of the will and to have power of attorney in the event of her being incapable of managing her affairs?

Answer Under the general principle of independence of Section 290, safeguards would be in place to prevent impairment of independence including ensuring no involvement with the relevant audit clients until such time as the shares are disposed of. However, under the specific requirements of s. 324CH(1) of the Act, if you are a member of the audit team for any of the audit clients, the beneficial interest in an audit client during probate may give rise to a conflict of interest situation that cannot be resolved within the 28-day period, at which time the firm would have to resign as auditor or you would have to remove yourself from the audit team. Under these circumstances the only way that the legal implications could be resolved is to make an application to ASIC for exemption under s. 341 and ask that the exemption be provided within the legislative time frame. The timing of this would unfortunately coincide with a difficult period in your life. Specific exemption may be difficult to achieve within the legislative time frame but may be the only remedy available to you and your firm. Refusal of executor responsibilities would not alter the outcome. However, except in the case of an enduring power of attorney that has not been effected, having a power of attorney may give rise to the appearance of a conflict of interest as you have control over the assets even though no immediate legal interest in the investment. You may apply for an exemption outlining the circumstances under ASIC's specific exemption provisions in s. 341of the Act.

4.7 Contractors/employees/consultants

Q4.7.1 I've been contracted as a consultant to an audit firm. Do I need to consider the independence requirements?

Answer The term 'consultant' is widely used with quite different and yet often interchangeable meanings. For example, the term is now used broadly to encompass:

- Employees (often those working part time)
- Retired partners
- Those offering specialist expertise either as individuals or organisations (also contractors).

The law relating to when a contractor is considered to be an employee is unclear, and the courts have taken differing approaches depending on the various facts.

However, in the context of Section 290, you will be considered to be an employee of the firm if you are a 'consultant' providing your services exclusively to a firm, charging your time to the firm and have entered into an agreement with the firm that the work you undertake will be treated in the same way as the work prepared by an employee of that firm.

Accordingly, where a 'consultant' is considered to be:

- **An employee of the firm** – then Para 290.149 provides that the firm is not able to continue to act as auditor, where an employee of the firm acts as a director, officer or employee in a position to exert direct and significant influence over the subject matter of the audit
- **A former partner of the firm** – then Paras 290.143 to AUST290.145.1 apply to limit the conditions under which the former partner may act as a director, officer or employee in a position to exert direct and significant influence over the subject matter of the audit.

Further, where any of the audit client's directors, officers and employees in a position to exert direct and significant influence over the subject matter of the audit are engaged as a consultant by the firm or by a partner of the firm, then Para AUST290.134.1 recognises that no safeguards could reduce the threat to an acceptable level. Accordingly, except for small proprietary companies, the only possible course of action is to terminate the consultancy arrangement or refuse to perform the audit engagement.

In contrast, the Corporations Act prohibitions on consultants should be considered to apply in the context of the legal definition of employee.

© The Australian Professional Joint Accounting Bodies

5. Networks

This information is based on a document prepared by the staff of the IESBA to illustrate the application of the network firm definition contained in APES 110 *Code of Ethics for Professional Accountants* and effective 1 July 2008. The definition of a network is relevant for independence purposes as a firm that is a member of a network is required to be independent of the audit clients of other firms within the network.

5.1 Network and network firms

290.14 An entity that belongs to a network might be a firm, which is defined in this Code as a sole practitioner, partnership or corporation of professional accountants and an entity that controls or is controlled by such parties, or the entity might be another type of entity, such as a consulting practice or a professional law practice. The independence requirements in this section that apply to a network firm apply to any entity that meets the definition of a network firm irrespective of whether the entity itself meets the definition of a firm.

290.15 If a firm is considered to be a network firm, the firm is required to be independent of the financial statement audit clients of the other firms within the network. In addition, for assurance clients that are not financial statement audit clients, consideration should be given to any threats the firm has reason to believe may be created by financial interests in the client held by other entities in the network or by relationships between the client and other entities in the network.

290.16 To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends upon the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. For example, a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at co-operation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is considered to be a network.

290.17 The judgment as to whether the larger structure is a network should be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgment should be applied consistently throughout the network.

290.18 Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is considered to be a network. However, the sharing of immaterial costs would not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product would not in itself create a network.

290.19 Where the larger structure is aimed at co-operation and the entities within the structure share common ownership, control or management, it is considered to be a network. This could be achieved by contract or other means.

290.20 Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is considered to be a network. For this purpose common quality control policies and procedures would be those designed, implemented and monitored across the larger structure.

290.21 Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is considered to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not considered to be a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision of a professional service.

© The Australian Professional Joint Accounting Bodies

290.22	Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is considered to be a network. A common brand name includes common initials or a common name. A firm is considered to be using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an assurance report.
290.23	Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, a firm should carefully consider how it describes any such memberships in order to avoid the perception that it belongs to a network.
290.24	If a firm sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the component may continue to use the name of the firm, or an element of the name, even though it is no longer connected to the firm. In such circumstances, while the two entities may be practising under a common name, the facts are such that they do not belong to a larger structure aimed at co-operation and are, therefore, not network firms. Those entities should carefully consider how to disclose that they are not network firms when presenting themselves to outside parties.
290.25	Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is considered to be a network. Professional resources include: • Common systems that enable firms to exchange information such as client data, billing and time records • Partners and staff • Technical departments to consult on technical or industry specific issues, transactions or events for assurance engagements • Audit methodology or audit manuals • Training courses and facilities.
290.26	The determination of whether the professional resources shared are significant, and therefore the firms are network firms, should be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be considered to be significant. The same applies to a common training endeavour. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Definitions

Firm	a. A sole practitioner, partnership or corporation of professional accountants b. An entity that controls such parties through ownership, management or other means; and c. An entity controlled by such parties through ownership, management or other means.
Network firm	A firm or entity that belongs to a network.
Network[3]	A larger structure: a. That is aimed at co-operation, and b. That is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

3. This definition is to be read in the context of the guidance provided in Paras 290.14 – 26.

© The Australian Professional Joint Accounting Bodies

5.2 Network firm examples

Some hypothetical associations are analysed to determine whether the particular association would be considered to be a network for independence purposes under Section 290 of APES 110. These examples are provided for illustrative purposes and are not intended to be, and cannot be, all inclusive. The examples are not a substitute for reading the full text of APES 110 and applying the guidance to the particular circumstances faced by an association. The determination of whether a particular association would be determined to be a network for independence purposes under APES 110 is a matter to be judged based on the particular facts and circumstances.

In these examples it is assumed that there are no unmentioned facts which would be relevant to the consideration as to whether the association would be considered a network.

Facts	Analysis	Conclusion
A is an association of 120 firms, operating in 120 different countries, established to provide global services to clients. Each firm is a member of A International but is a separate and distinct legal entity. As a member of A International, each firm agrees to common quality control policies and procedures designed by A International and which are implemented and monitored throughout the association. Each firm uses the name A in marketing and promotional material and also when signing assurance reports. There are many common clients within the association.	**A** is a larger structure which is aimed at co-operation. The entities within the larger structure: • Share common quality control policies and procedures which are designed, implemented and monitored throughout the larger structure • Use a common brand name when the firms sign assurance reports Either of these factors would be sufficient to make the association a network.	**A** is a network comprised of all the 120 firms.
B is an association of firms, operating in 120 different countries, established to provide global services to clients. Each firm is a separate and distinct legal entity. All of the firms are listed in the global directory of B. When performing assurance engagements, all firms use a common audit methodology which was developed by B. Each firm implements its own system of quality control policies and procedures and there is no shared monitoring across the association. All firms mention that they are a member of B association in marketing and promotional material. Eighty firms use the name when signing assurance reports. There are numerous common clients between these 80 firms. The 40 other firms use a local name. There are no common clients between these 40 firms.	**B** is a larger structure which is aimed at co-operation. The 80 firms within the larger structure that use the name of B when signing assurance reports are a network. The other 40 firms, that use a local name when signing assurance reports, are not part of a network. These 40 firms should, however, carefully consider how their promotional material describes the membership in B to avoid the perception that they belong to a network.	**B** is a network comprised of the 80 firms that use the B name in the signing of assurance reports. The other 40 firms are not part of the network.
C is an international association of firms formed to provide global services to clients. Each firm is a separate and distinct legal entity. Under the profit sharing arrangement, 30 per cent of the profit of each firm is pooled and redistributed to individual firms based on a pre-defined formula.	**C** is a larger structure which is aimed at co-operation. The larger structure is clearly aimed at profit sharing.	**C** is a network.

© The Australian Professional Joint Accounting Bodies

Facts	Analysis	Conclusion
D is a national association of firms formed to exchange ideas, information and expertise with the goal of improving the quality and profitability of the firms within the association. Each firm is a separate and distinct legal entity. The association conducts a number of educational programs each year covering matters such as changes in accounting standards. The association also distributes a monthly newsletter on matters of interest. All firms within the association are listed in a members' directory. Member firms use the directory to locate other members for matters such as referral of work or for identifying another firm with whom to partner for a specific piece of work.	**D** is a larger structure which is aimed at co-operation but it is not clearly aimed at profit or cost sharing and does not share common ownership, control or management, common quality control policies and procedures, a common business strategy, use of a common brand name or a significant part of professional resources.	**D** is not a network.
E is an association of firms in one country. Each firm is a separate and distinct legal entity. The firms use a common audit methodology and share a common technical department. Under the association agreement, all financial statements must be reviewed by the technical department before the audit report is issued. The advice from the technical department, either on review of the statements or through consultation during the audit, must be followed by the audit partner.	**E** is a larger structure aimed at co-operation. The use of a common audit methodology is not sufficient to conclude that the larger structure shares significant professional resources but there is also sharing of a technical department and the advice from this department is mandatory. This fact, coupled with the requirements for the technical department review of financial statements before release of the audit opinion, would indicate that the larger structure does share significant professional resources.	**E** is a network.
F is an association of firms formed to provide global services to clients. Each firm is a separate and distinct legal entity. The firms within the association share common quality control policies and procedures. These policies and procedures were designed by F and have been implemented across the association and are monitored across the association. There is annual communication across the association of the scope, extent and results of the monitoring process. Under the association agreement the monitoring of each firm is performed by a group of people from a central location. The monitoring group has the authority to make specific recommendations for action. The conditions of membership require firms to take the recommended action.	**F** is a larger structure aimed at co-operation. The larger structure shares common quality control policies and procedures.	**F** is a network.
G is an association of firms in one region. Each firm is a separate and distinct legal entity. A condition of membership of the association is that each firm will ensure its system of quality control for assurance and other related services engagements complies with APES 320 *Quality Control for Firms*.	**G** is a larger structure aimed at co-operation but does not share common quality control policies and procedures. The agreement to ensure firms' system of quality control complies with APES 320 is not the same as sharing common quality control policies and procedures.	**G** is not a network.

© The Australian Professional Joint Accounting Bodies

Facts	Analysis	Conclusion
H is an association of firms in one country formed to exchange ideas, information and expertise with the goal of improving the quality and profitability of the firms within the association. Each firm is a separate and distinct legal entity. The association conducts a number of educational programs each year covering matters such as changes in accounting standards. The association also distributes a monthly newsletter on matters of interest. All firms within the association are listed in a members' directory. Member firms use the directory to locate other members for matters such as referral of work or for identifying another firm with whom to partner for a specific piece of work. Many firms within the association indicate on their stationery and promotional materials that they are a member of H association. None of the firms use the H name in signing of assurance reports.	**H** is a larger structure which is aimed at co-operation but it is not clearly aimed at profit or cost sharing and does not share common ownership, control or management, common quality control policies and procedures, a common business strategy, use of a common brand name or a significant part of professional resources. The reference by some firms to the membership of H association does not in itself create a network firm relationship. Such firms should, however, be careful how they describe the relationship to avoid the perception that the association is a network.	**H** is not a network.
I is an association of 10 firms in one country formed to share expertise to develop audit manuals to comply with new auditing standards. Each firm pays one-tenth of the cost of a small group of experts who have responsibility to develop the audit manuals.	**I** is a larger structure which is aimed at co-operation but it is not clearly aimed at profit or cost sharing and does not share common ownership, control or management, common quality control policies and procedures, a common business strategy, use of a common brand name or a significant part of professional resources. The sharing of the costs associated with the development of the audit manuals does not in itself create a network relationship.	**I** is not a network.
J is an association of 10 firms in one country formed to use economies of scale in delivery of IFRS training to staff on within the firms. Each firm pays one-tenth of the cost of the development of the courses which are then delivered to all staff within each of the 10 firms.	**J** is a larger structure which is aimed at co-operation but it is not clearly aimed at profit or cost sharing and does not share common ownership, control or management, common quality control policies and procedures, a common business strategy, use of a common brand name or a significant part of professional resources. The sharing of the costs associated with the development of the IFRS training courses does not in itself create a network relationship.	**J** is not a network.

© The Australian Professional Joint Accounting Bodies

6. Questions and answers on rotation requirements for listed clients

Background to the current rotation requirements for listed entities

For a full understanding of the rotation requirements that can apply to auditors of listed entities who have acted as a lead engagement partner we need to look back to 2002, as the obligations could have impacted on listed audit clients since the 1997 year. Key aspects include:

When	Key issues
2002	• A rotation requirement for lead engagement partners of seven years was introduced. This was applicable to assurance reports dated on or after 31 December 2003 and required a time-out period of two years.
2003	• Additional guidance was issued by the professional bodies in 2003, which drew on IFAC's Interpretation 2003-01 to allow a transitional period of two years. The introduction of the rotation requirements in 2002 was seen as an example of circumstances in which some degree of flexibility over the timing of rotation is accepted.
2004	• F.1 was revised to achieve alignment with CLERP 9 • The rotation requirement was extended to include the 'audit review partner' • The rotation period was reduced to five years within a seven-year period, and was applicable to financial reporting periods beginning on or after 1 July 2006 • The time served is from the commencement of the financial period in which the lead engagement partner and the audit review partner served in those roles, not 1 July 2006 • The 2003 guidance did not apply as the reduction in the time period to five years was considered to have provided sufficient time to members providing audit services to listed entities to implement these revised rotation requirements.
2006	• The joint Code of Professional Conduct, which included F.1, was replaced by APES 110. Section 290 is now the standard independence reference • The rotation requirements were extended to include the Engagement Quality Control Reviewer (EQCR) • Note: EQCR is defined as 'a Partner, other person in the assurance practice, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report' • Refer to APES 320 *Quality Control for Firms*, Paras 60-73 for the requirements relating to the EQCR.

The following is an extract of the current rotation requirements of Section 290:

Long Association of Senior Personnel With Assurance Clients

General Provisions

290.153 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 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.

© The Australian Professional Joint Accounting Bodies

Audit Clients That are Listed Entities[4]

290.154 Using the same:

- Lead Engagement Partner or
- Audit Review Partner (if any) or
- Engagement Quality Control Reviewer

on an audit over a prolonged period may create a familiarity threat.

This threat is particularly relevant in the context of the audit of a Listed Entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly, in respect of the audit of Listed Entities:

a. The Lead Engagement Partner, the Audit Review Partner (if any) and the Engagement Quality Control Reviewer should be rotated after serving in any of these capacities, or a combination thereof, for a pre-defined period, no longer than five financial years within a seven year period and
b. Such an individual rotating after a pre-defined period should not participate in the Audit Engagement until a further period of time, no less than two years, since the end of the financial year following the end of the pre-defined period has elapsed.

Service as a Lead Engagement Partner, Audit Review Partner (if any) or Engagement Quality Control Reviewer in respect of an Audit Engagement is cumulative for the purposes of this requirement.

The pre-defined period of five years within a seven-year period applies to an audit of the financial report for a financial year or an audit or review of the financial report for a half-year in a financial year, if the financial year begins on or after 1 July 2006.

Prior to that time, the previous pre-defined period of seven years continues to apply.

290.155 When an Audit Client becomes a Listed Entity the length of time the Lead Engagement Partner, Audit Review Partner (if any) or Engagement Quality Control Reviewer have served the Audit Client in that capacity should be considered in determining when the individual should be rotated. However, the person may continue to serve as the Lead Engagement, or Audit Review Partner (if any), or Engagement Quality Control Reviewer for two additional years before rotating off the Engagement, provided this does not exceed seven years as at 1 July 2006.

290.156 While the Lead Engagement Partner, Audit Review Partner (if any) and Engagement Quality Control Reviewer 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 person'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 person(s) 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 person is not rotated after such a pre-defined period equivalent safeguards, including the obtaining of an exemption under the Corporations Act, should be applied to reduce any threats to an acceptable level.

290.157 When a firm has only a few people with the necessary knowledge and experience to serve as Lead Engagement Partner, Audit Review Partner or Engagement Quality Control Reviewer on an Audit Client that is a Listed Entity, rotation may not be an appropriate safeguard. In these circumstances the Firm should apply other safeguards including the obtaining of an exemption under the Corporations Act, 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.

4. See also Interpretation 2003-02 of the Code.

© The Australian Professional Joint Accounting Bodies

Member questions

Following are a series of questions and answers addressing a range of members' queries on rotation that have arisen since F.1/Section 290 was issued and CLERP 9 implemented. These questions are to assist auditors in interpreting both the statement and legislation.

Individual circumstances should be tested against Section 290 and the Act, and professional legal advice obtained if necessary.

Section 290 recognises that using the same lead engagement or review partners 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. The significance of the threat will depend on a number of factors such as:

- The length of time that the individual has been a member of the audit team
- The role of the individual on the audit team
- The structure of the firm.

The following questions and answers provide a range of examples applying the pre-defined rotation periods for listed entities under Section 290.

Abbreviations

Para	**Paragraph**
s.	**section**
the Act	***Corporations Act 2001***

6.1 Applying the five-year rotation period

Q6.1.1 Will a partner who was the lead engagement partner for a client with a 30 June year-end in 2003, 2004, 2005 and then the audit review partner in 2006 and 2007, be eligible to act in either role in 2008?

Answer No. As the role of lead engagement partner and audit review partner are aggregated, the partner is not eligible to act as either lead or review partner in 2008.

Financial year	2003	2004	2005	2006	2007	2008	2009	2010
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✗	✗	✓

Q6.1.2 Will the lead engagement partner for a client with a 30 June financial year in 2006, 2007, and 2008 be eligible to act as either lead engagement or audit review partner after 1 July 2008?

Answer Yes. The partner will be eligible to act in either role for a further two successive financial years (that is, 2009 and 2010) but cannot then act in either role in 2011. Should the partner take a break in 2009 and 2010 they would be again eligible to act as lead engagement partner, audit review partner or engagement quality control reviewer (EQCR) in 2011.

Financial year	2006	2007	2008	2009	2010	2011
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✗

© The Australian Professional Joint Accounting Bodies

Q6.1.3 A lead engagement partner completed five years in the role of lead engagement partner at the 2008 year-end audit. Could they be permitted to continue in the role of lead engagement partner for the 2009 year's audit?

Answer As the 2009 audit engagement would be the sixth year that the partner serves in the capacity of lead engagement partner, that partner is required to rotate off the engagement.

Financial year	03/04	04/05	05/06	06/07	07/08	08/09	09/10
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✗	✗

Q6.1.4 Assume that the lead engagement partner had only been out one year (for example, the 2008 audit). Can the partner return to the engagement in 2009, and, if so, for how long?

Answer The partner would not be able to return to the engagement in 2009. The partner would have to complete the requisite time-out period specified under Para 290.154. Since the partner has been out for only one year, they would have to be out for an **additional year** before returning to the engagement.

Q6.1.5 Will the lead engagement partner for a client with a 31 December year-end in 2006 and 2007 be eligible to act as either lead engagement partner or audit review partner after 1 January 2008?

Answer Yes. The partner will then be eligible to act in either role for a further two successive financial years (that is, 2009 and 2010) but cannot then act in either role in 2011 unless the partner has taken a break.

Calendar year	2006	2007	2008	2009	2010
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓

Q6.1.6 A lead engagement partner had completed three years in the role of lead engagement partner prior to 31 December 2008. For how many years would they be permitted to continue in the role of lead engagement partner?

Answer The partner could serve for two additional years as lead engagement partner since prior service in that role counts in determining the rotation requirements for lead engagement partners.

Calendar year	2006	2007	2008	2009	2010
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓

© The Australian Professional Joint Accounting Bodies

6.2 Non-listed to listed client

Q6.2.1 A firm has already served as the auditor of a non-listed company for four financial years using the same lead engagement partner when the client goes through an IPO in March 2008. What are the rotation requirements for the lead engagement partner?

Answer Since the company has become a listed entity, the partner is now subject to the rotation requirements, which date from their appointment to the then non-listed client.

The lead engagement partner has acted in that role for each of the 2004, 2005, 2006 and 2007 years, before the rotation provisions of Section 290 of the Code of Ethics apply to the 2008 audit of the financial year beginning 1 July 2007.

Accordingly, the lead engagement partner can continue to act in that role for the 2008 year, but should rotate off for the 2009 audit.

Financial year	2004	2005	2006	2007	IPO	2008	2009
Eligible to play a significant role in the audit	✓	✓	✓	✓	March 2008	✓	✗

Paragraph 290.154 provides that the time served is from the commencement of the financial period in which the lead engagement partner, the audit review partner (if any) or EQCR served in those roles, not the date the audit client listed. In accord with the international standard, Para 290.155 also provides for two additional years when an audit client becomes a listed entity.

However, the Corporations Act does not specifically address the situation where an audit client becomes a listed entity. The Act's rotation requirements (s. 324DA, DB,DC and DD) apply to a financial year commencing on or after 1 July 2006, to listed entities, where an individual played a significant role in the audit for 5 successive financial years. Further, under the commentary to the CLERP 9 transitional arrangements applying to the rotation obligations, 'where a person has already conducted three or more successive annual audits for a listed company or scheme at the time that the legislation takes effect, they, their audit firm and the client company or scheme will need to be aware that the auditor must be replaced for the audit following the date at which the rotation provisions take effect (that is, two years following commencement of the Act)', that is, two years following 1 July 2004.

Accordingly, it would appear that the legislation was intended to be prospective in its application regarding the rotation requirements (on 1 July 2006) but recognised the role played by the lead engagement partner and audit review partner prior to 1 July 2006. It would thus be prudent to consider all the time served as a lead engagement partner, audit review partner (if any) or EQCR from the commencement of the financial period in the individual served in those roles, not the financial period in which the client listed. In all such circumstances when a person is not rotated after the pre-defined five-year period equivalent safeguards, including the obtaining of relief under the Corporations Act should be applied to reduce any threats to an acceptable level.

6.3 Opting out during the last rotation period

Q6.3.1 The 2008 audit of a listed client with a 30 June year-end will be the last audit of the client for the person currently serving as the lead engagement partner. Section 290 specifies that the firm is not independent when the lead engagement partner has served for more than five years. How should the transition be handled?

Answer The intention of the rotation rules is to allow a lead engagement partner to finish the current audit (for example, the financial year 2008 audit). The lead engagement partner could complete the current audit, even though work would extend beyond 1 July 2008, without impairing the firm's independence. However, care must be taken to ensure that the partner is not involved in work that may be performed with respect to the first quarter of the 2009 reporting period. Since some of this work may be performed simultaneously with the audit, the firm will need to carefully monitor the transition to ensure compliance with the rotation requirements.

Financial year	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✗

© The Australian Professional Joint Accounting Bodies

6.4 Re-auditing prior periods

Q6.4.1 A firm accepts a new audit client that had previously been audited by another firm. In the course of auditing the current period's financial statements, it was determined that the newly engaged firm should re-audit the prior two periods. For the purposes of the partner rotation provisions of the independence rules, does this engagement constitute one year or three years of service by the audit partners?

Answer This constitutes one year for the purposes of determining when the partners would need to rotate.

This is a different situation from the IPO situation in Q6.2.1. In that situation, the firm and its partners had an established relationship with the client for more than three years before the company listed. In this situation, there is no previous relationship with the client. One of the objectives of partner rotation is for the firm to have a 'fresh look' at the company, in order to safeguard against the familiarity threat. In this situation, there has not been an ongoing relationship with the management or the company. Therefore, the fact that multiple periods were audited does not create a need to accelerate the 'fresh look'. The same would be true for a company when it prepares for listing where it had never had its previous financial statements audited and the auditor concurrently audited all three periods included in the IPO.

6.5 Where a partner changes firm

Q6.5.1 Partner A is an audit partner with Audit Firm Z. Partner A has served as the lead engagement partner on the audit of Company E for three years. Partner A leaves Audit Firm Z to join Audit Firm Y. In doing so, Partner A takes Company E with him or her to join Audit Firm Y. After joining Audit Firm Y, how many additional years may Partner A serve as the lead engagement partner for Company E before they must rotate off the engagement?

Answer The rotation requirement is, in part, directed towards the need to have a fresh look with respect to the audit client. Since Partner A has a continuing relationship with Company E, the prior service would count in the determination of the partner rotation requirement.

As a consequence, Partner A would be able to serve as the lead engagement partner on Company E's audit for two additional years (thus, serving the client for five consecutive years) upon joining Audit Firm Y. At that point, Partner A would be required to rotate off the engagement for the required two-year time-out period.

6.6 Changes in fiscal year-end

Q6.6.1 A client changes its fiscal year-end. As a consequence, in the year of change, its 'annual' financial statements would cover less than 12 months. How would this 'short' period be counted in determining when the 'audit partner' should rotate?

Answer The lead engagement partner should be rotated after a pre-defined period, no longer than five years. If the listed company is required to undertake a separate financial statement audit for a shorter period, then that period constitutes a 'year' for the purposes of the partner rotation requirements. If, however, the listed company is not required to undertake a separate financial statement audit for the period, then that period does not constitute a 'year' for the purposes of the partner rotation requirements.

© The Australian Professional Joint Accounting Bodies

6.7 Audit review partner

Q6.7.1 We are a small practice and due to the size of the audits we conduct, we have never appointed an audit review partner although we do have a manager who is a Chartered Accountant and has responsibility for technical and quality control issues for the audit division. Under changes to the Corporations Act and Section 290 are we now required to appoint an audit review partner?

Answer No, the Corporations Act does not mandate the appointment of an audit review partner, nor do auditing or professional standards.

Under Auditing Standard ASA 220, applicable for financial periods commencing on or after 1 July 2006, an (EQCR) must be appointed for listed entity audits, but will not be mandatory for other audits. The extent of the work required to be performed by the EQCR as stated in the relevant auditing standards 'depends on the complexity of the audit engagement and the risk that the auditor's report might not be appropriate in the circumstances' (Para 37 of AUS 206, Para 43 of ASA 220). Also as stated in these auditing standards, the ECQR may be 'a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the auditor's report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the auditor's report' (Para 8 of ASA 220).

The APESB issued APES 320 *Quality Control for Firms* in May 2006. It requires the firm to implement a policy of appointing an EQCR, again only for the audit of listed companies.

Although Section 290 refers to an 'audit review partner', the statement does not require the appointment of such a partner. The definition of an audit review partner in APES 110 'does not extend to an auditor who performs merely a technical role in the audit and whose contact with the audit client is not material to the day-to-day conduct of the audit as a whole'.

6.8 Engagement quality control reviewer

Q6.8.1 A firm has acted as auditor for a listed client for the past few years and is reviewing their options in relation to meeting the rotation requirements in the future. The current proposal is:

Partner	Lead engagement partner	Audit review partner	EQCR	Ineligible to play a significant role in the audit
A (recently retired from the firm)	2003, 2004, 2005, 2006, 2007	N/A	2010	2008, 2009
B	2008	2005, 2006, 2007	2009	2010, 2011
C	2009, 2010	N/A	2008	N/A

Partners A and B do not intend to appoint an audit review partner in 2008 and to request former Partner A act as the EQCR on the 2010 audit. Does this meet the rotation requirements?

Answer Yes. It is not mandatory to appoint an audit review partner (see Q6.7.1 above) and the EQCR may be a suitably qualified external person (refer APES 110 Definitions).

© The Australian Professional Joint Accounting Bodies

6.9 Other roles

Q6.9.1 Partner A has served as either the lead engagement or EQCR on the audit of Company X for five years and may not act in either role for two years. What other role/s may Partner A undertake in respect of the client group during that period?

Answer The rotation requirements do not permit Partner A to act as the lead engagement, review partner (if any) or EQCR. However, he may take a role that is clearly insignificant to the conduct of the audit of Company X during that period.

The relevant factors to be considered in relation to that role include:

- The technical nature and/or significance of the role itself
- Time involvement
- Contact with the client.

As the rotation requirement is in part directed towards the need to have a fresh look with respect to the audit client, it would be inappropriate for the lead engagement, audit review partner or EQCR during that period to undertake a role which involved extensive meetings with the client's senior management.

6.10 Changing from the seven- to five-year rotation periods

Q6.10.1 The 2006 audit of a listed client with a 30 June year-end was the seventh audit of the client for the person currently serving as the lead engagement partner. How should the transition to the five-year period have been handled and when can the lead engagement partner next play a significant role in the audit?

Answer The period to be considered is the period from the date of the financial statements that were first reported on in the capacity of lead engagement partner (in this case, 1 July 1999).

The length of time the lead engagement partner has served the audit client should be considered in determining when rotation should occur (in this case, 30 June 2006).

Accordingly, the lead engagement partner should not serve in that capacity in the 2007 and 2008 audits, but may again play a significant role in the 08/09 audit.

Financial year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✓	✓	✗	✗

Should such rotation have not occurred, the additional requirements of Paras 290.156 and 290.157 apply to require equivalent safeguards in order to reduce any threats to an acceptable level. These safeguards must include the granting of relief by ASIC under s. 324A.

© The Australian Professional Joint Accounting Bodies

Q6.10.2 A lead engagement partner served for seven years and was off for two years prior to the effective date of F.1 (31 December 2003) for a listed client with a 31 December year-end, that is, the lead engagement partner completed their seventh year of service on the engagement for the 2001 audit. They subsequently did not participate in the audit for either 2002 or 2003. Can the partner return to the engagement in 2004, and, if so, for how long?

Answer Yes, but only until the completion of the 2008 audit.

In the context of F.1 applicable 31 December 2003, the partner could serve a further seven years as lead engagement partner beginning with the 2004 audit.

However the subsequent December 2004 revisions to F.1 (now Section 290) apply a rotation period of five years to financial periods beginning on, or after, 1 July 2006.

Consequently, the partner can return to the engagement in 2004, but may remain in that role only until the completion of the fifth/2008 audit.

Calendar year	1995 – 2001 inclusive	2002	2003	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓ x 7	✗	✗	✓	✓	✓	✓	✓	✗

Q6.10.3 Assume the lead engagement partner had only been out one year (for example, the 2002 audit) before the effective date of F.1 (31 December 2003). Can the partner return to the engagement in 2003, and, if so, for how long?

Answer The partner would not be able to return to the engagement in 2003. The partner would have to complete the requisite time-out period specified under F.1 (now Section 290). Since they have been out for only one year, they could not return to the audit for an additional year.

Calendar year	1995 – 2001 inclusive	2002	2003
Eligible to play a significant role in the audit	✓ x 7	✗	✗

Q6.10.4 A lead engagement partner had completed seven or more years in the role of lead engagement partner prior to the 2004 year-end. Could they be permitted to continue in the role of lead engagement partner for the 2004 year's audit?

Answer The F.1 provisions relating to partner rotation are applicable when the assurance report is dated on or after 31 December 2003. If the audit engagement of the first year ending on or after that date is the seventh year that a partner serves in the capacity of lead engagement partner, that partner could complete such audit before being required to rotate off the engagement.

However, the partner could only participate as the lead engagement partner in the audit for the years beginning on or after 1 January 2004 and 1 January 2005 on the basis of the two-year transition period. Refer to Section 8 of this guide, Appendix 3.

Financial year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Eligible to play a significant role in the audit	✓ x 7+	✓	✓	✗	✗	✓	✓	✓	✓	✓

Q6.10.5 Will a partner who is the lead engagement partner for a client with a 30 June financial year in 2001, 2002, 2003, 2004, 2005 and 2006 be eligible to act as either the lead engagement or audit review partner in 2007?

Answer No. As the partner has acted as lead engagement partner for more than five years within a seven-year period on 1 July 2006, the partner is not eligible to act as either lead engagement partner or audit review partner in 2007 or 2008.

Financial year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✓	✗	✗	✓

© The Australian Professional Joint Accounting Bodies

Q6.10.6 Why was the lead engagement partner able to act in that capacity in the 30 June 2006 year?

Answer The lead engagement partner was able to act in that capacity in the 30 June 2006 year as F.1 (issued May 2002 and applicable December 2003) then permitted a rotation period of seven years. Subsequent revisions to F.1 in December 2004, to achieve alignment with CLERP 9, varied the period to five years for financial periods beginning on or after 1 July 2006. These provisions are now contained in Section 290.

Q6.10.7 The 2006 audit of a listed client with a 30 June year-end will be the seventh audit of the client for the person currently serving as the lead engagement partner. Section 290 specifies that the firm is not independent when the lead engagement partner has served for more than five years. How should the transition be handled?

Answer The period to be considered is the period from the date of the financial statements that were first reported on (in this case, 1 July 1999) in the capacity of lead engagement or audit review partner. The rotation revisions to F.1 in December 2004, applicable to financial periods beginning on or after 1 July 2006, constitute an example of a circumstance in which some degree of flexibility over the timing of rotation may be necessary, as recognised in Para 290.144.

The additional guidance issued by the Institute and CPA Australia in 2003 drew on IFAC Interpretation 2003-01 and allowed a transitional period of two years. Refer to Section 8 of this guide, Appendix 3.

However, the 1 July 2006 transition date is considered to have provided sufficient time to members providing audit services to listed entities to implement the rotation requirements.

Consequently, while the length of time the lead engagement partner has served the audit client should be considered in determining when rotation should occur (in this case, 30 June 2006) the partner may not continue to serve as the lead engagement partner for the financial year ending 30 June 2007 and must rotate off the engagement.

Financial year	1999 – 2001	2002	2003	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓ x 3	✓	✓	✓	✓	✓	✗	✗	✓

Q6.10.8 Will a partner who is the lead engagement partner for a listed client with a 31 December year-end in 2001, 2002, 2003, 2004 and 2005 be eligible to act as either the lead engagement partner or audit review partner in 2006?

Answer Yes. As the 2006 financial year commenced prior to 1 July 2006, the December 2004 F.1 rotation revisions to align with CLERP 9 (now Section 290) do not apply until the commencement of the 2007 financial year. The partner has acted as lead engagement partner for five years as at 1 January 2006, and is eligible to act as either lead engagement or audit review partner in 2006. However, the partner is then required to rotate off the engagement for at least the two years of 2007 and 2008.

Calendar year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓	✓	✓	✓	✓	✓	✗	✗	✓

Q6.10.9 For a listed client with a 31 December year-end, the lead engagement partner completed their seventh year of service on the engagement for the 2001 audit. They subsequently did not participate in the audit for either 2002 or 2003. Can the partner return to the engagement in 2004, and, if so, for how long?

Answer The partner can serve as lead engagement partner beginning with the 2004 audit.

However, the lead engagement partner is then limited to serving in the role for five years within a seven-year period.

In this example, within the seven-year period to 30 June 2006 the partner has served in the five years of 2000, 2001, 2004, 2005 and 2006 and did not participate in the 2002 and 2003 years.

Financial year and prior	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Eligible to play a significant role in the audit	✓ x 6	✓	✗	✗	✓	✓	✓	✓	✓	✗

© The Australian Professional Joint Accounting Bodies

Q6.10.10 A lead engagement partner had completed seven years in that role at the completion of the 31 December 2005 audit. Could the partner be permitted to continue in the role of lead engagement partner for the 2006 year's audit?

Answer The F.1 requirements relating to partner rotation are applicable when the assurance report is dated on or after 31 December 2003. So the partner could only participate as the lead engagement partner in the audit for the year beginning on 1 January 2006 on the basis of the two-year transition period. Refer Section 8 of this guide, Appendix 3.

However, the December 2004 F.1 rotation revisions (now Section 290) then apply to financial years beginning on or after 1 July 2006.

As the audit engagement for the 2007 year exceeds the pre-defined fifth year within the previous seven, the lead engagement partner could not participate as lead engagement partner in the audit for the year beginning on 1 January 2007.

Calendar year & prior	2006	2007	2008	2009	2010	2011	2012	2013
Eligible to play a significant role in the audit	✓ x 7	✗	✗	✓	✓	✓	✓	✓

Q6.10.11 A lead engagement partner served for seven years and was off for two years prior to the effective date of F.1 (31 December 2003) for a listed client with a 31 December year-end, that is, the lead engagement partner completed their seventh year of service on the engagement for the 2001 audit. The partner subsequently did not participate in the audit for either 2002 or 2003. Can the partner return to the engagement in 2004, and, if so, for how long?

Answer The partner can recommence with the 2004 audit but needs to consider the impact of the December 2004 F.1 rotation revisions (now Section 290) as they apply to financial years beginning on or after 1 July 2006, that is, the 2007 audit. Accordingly, the partner could not participate in the 2009 and 2010 audits.

Calendar year & prior	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Eligible to play a significant role in the audit	✓ x 7	✗	✗	✓	✓	✓	✓	✓	✗	✗

6.11 Listing on an overseas exchange

Q6.11.1 Our firm acts as auditor of a client that is only listed on an overseas exchange? Do the Corporations Act and Section 290 standards for listed entities, such as rotation, apply to the entity?

Answer The Act defines 'a company, managed investment scheme or other body as listed if it is included in the official list of a prescribed financial market operated in this jurisdiction'. Chapter 2C – Registers identifies a prescribed financial market to mean any of the following:

- Australian Stock Exchange Limited
- Bendigo Stock Exchange Limited
- Stock Exchange of Newcastle Limited.

However, APES 110:

- Defines a listed entity as 'an entity whose shares, stock or debt are quoted or listed on a recognised stock exchange, or are marketed under the regulations of a recognised stock exchange or other equivalent body'
- Recognises that 'some jurisdictions may have requirements and guidance that differ from this Code. Members should be aware of those differences and comply with the more stringent requirements and guidance unless prohibited by law or regulation'.

Accordingly, the rotation requirements of APES 110 have wider application than the Act.

© The Australian Professional Joint Accounting Bodies

7. Ethical dilemmas

7.1 A common scenario – INTHEBLACK, May 2005

I am a sole practitioner who has worked with a small business client for eight years. According to APES 110 Section 290, I understand that I must now refer my client to another accountant for their audit engagement, but feel I will lose this valuable client to a larger firm. What should I do?

Response

It is a fundamental principle of the accounting profession that a member who provides assurance services shall do so with unimpaired professional judgment and objectivity, and shall be seen to be doing so by a reasonable observer. This principle is the foundation for public confidence in the reports of assurance providers.

The confidence that professional judgment has been exercised depends on the unbiased and objective state of mind of the reporting accountant, both in fact and appearance.

The requirement for independence applies to all members and firms and is found in APES 110 *Code of Ethics for Professional Accountants* and, in particular, Section 290 of the Code. The Code is based on a conceptual framework which introduces the positive requirement for members and firms to:

- Consider independence before and throughout each engagement
- Consider whether any 'threats' to independence exist
- Where threats are identified, consider whether there are 'safeguards' that exist or may be applied to eliminate the threat or reduce it to an acceptable level
- Where safeguards are found to be inadequate, decline or discontinue the engagement
- Notwithstanding the analysis of threats and safeguards, consider whether there are any 'prohibitions' that would preclude the undertaking or completion of the proposed engagement.

Referring to the question raised, does Section 290 preclude auditing an entity where the books are prepared by the auditor?

In order to address this question, it is first necessary to establish the exact nature of the engagement. The following are examples of different types of engagements which may exist:

- Where the accounting records are substantially prepared by the client and the information provided to the auditor is used to complete a pro-forma set of accounts, for which the client takes responsibility
- Where the client provides original documents, invoices etc., and the journal entries, general ledger and accounts are prepared by the auditor
- Where the company is not a trading entity and has very few transactions the client will often expect the auditor to record these few transactions in the books prior to preparing and auditing the financial statements. In these circumstances each transaction and balance can be traced directly to third party records. The auditor is not required to recalculate figures or make other judgments on how balances should be derived or treated as all balances tie directly to third party provided documents.

Threats identified

In all cases, there is a self-review threat which arises where the auditor is reviewing their own work or is responsible for the work of the preparer. There may also be a familiarity threat given the length of association which may make the auditor more sympathetic to the client's interests.

Objective assessment in each of the three scenarios

- Audit independence should not be impaired in the first scenario as the client is responsible for the financial statements
- Audit independence is impaired in the second scenario due to a self-review threat
- Auditor independence is not compromised in the third scenario when all balances tie directly to third party documents. However, as the number of transactions increases the likelihood of the auditor being able to maintain independence will decrease, as judgments will increasingly need to be made and balances will no longer simply agree to third party documents. Once the auditor makes judgments, such as assessing the value of investments, independence is likely to be impaired.

© The Australian Professional Joint Accounting Bodies

Possible safeguards

Safeguards to reduce the self-review threat to an acceptable level could include:

- Having the accounting records and books prepared to trial balance stage by the client with the client taking responsibility for the financial statements
- Having the client's management approve the journal entries during a review of the financial statements with the client, or by the client's management approving the financial statements. This approval may also be specifically included in the management representation letter.

Providing technical assistance to clients is an appropriate method of promoting fair presentation of financial statements. However, if the member is required to prepare a journal entry to record a material complex transaction, the client's lack of accounting knowledge may mean that simply reviewing the journal entry with the client is not sufficient to reduce the self-review threat to an acceptable level.

Ultimately, the assessment as to whether independence is impaired is based on judgment taking into account the characteristics of the engagement. However, it is important when assessing independence to apply the framework contained in Section 290 and to document all threats to independence together with any safeguards applied to reduce or eliminate such threats.

7.2 Testing independence – *Charter*, November 2007

See article on pages 46 – 47.

7.3 Making the hard decisions – *National Accountant*, Dec/Jan 2007

See article on pages 48 – 51.

© The Australian Professional Joint Accounting Bodies

testing independence

Just how easy is the test for independence of former auditors joining the board?

Story Geoff Brayshaw FCA

Recently, when invited to join the board of a publicly listed company, audited by my previous firm, I had cause to read the independence requirements of the Corporations Act 2001 with a little more than academic interest. The applicable legislation is found in Part 2M.4 Division 3, and contained in ss324CA-324CK, and were introduced effective from 1 July 2004.

The particular requirement which relates to multiple former audit firm (company) partners contained at s324CK is clear in its application and needs no explanation. It was not relevant to my situation.

Similarly, s324CI operates to prohibit a former partner from being appointed an officer of a listed public company within a period of two years where the former audit partner had at any time prior to retiring from the partnership (or audit company) been a professional member of the audit team. This also needs little if any clarification.

The third leg of the Corporations Act 2001 which former partners need apply is the Independence Test. This test is described in s324CF(7) as follows;

A person satisfies the independence test in this subsection in relation to a firm if the person:
(a) does not influence the operations or financial policies of the accounting and audit practice conducted by the firm
(b) does not participate, or appear to participate, in the business or professional activities of the accounting and audit practice conducted by the firm
(c) does not have any rights against the firm, or the members of the firm, in relation to the accounting and audit practice conducted by the firm, in relation to the termination of, or the value of, the person's former partnership interest in the firm
(d) has no financial arrangements with the firm in relation to the accounting and audit practice conducted by the firm, other than:
(i) an arrangement providing for regular payments of a fixed, predetermined dollar amount which is not dependent, directly or indirectly, on the revenues, profits or earnings of the firm, or
(ii) an arrangement providing for regular payments of a dollar amount where the method of calculating the dollar amount is fixed and is not dependent, directly or indirectly, on the revenues, profits or earnings of the firm, and
(e) without limiting paragraph (d), has no financial arrangement with the firm to receive a commission or similar payment in relation to business generated by the person for the accounting and audit practice conducted by the firm.

Paragraphs (a), (b) and (e) above operate quite exclusively to each other and appear not to attract any great issues as to what is meant, or how they might attract an independence perception should they apply to a former partner.

In simple terms, a person cannot remove the actuality of his/her former involvement with an accounting firm (company). These sections operate to ensure a former partner does not continue some latent form of ongoing attachment by virtue of roles such as consulting to, lending one's name to or proactively directing organisations/entities toward a former firm for some form of consideration.

Paragraph (d)(i) and(ii) appear to cover the typical circumstance of a former partner being paid out over a period of time as described in a partnership agreement.

RETIREMENT

Typically upon retirement, a partner's existing capital, current account, retirement allowances etc are accumulated to the date of retirement and crystalised/aggregated and the payout scheduled in accordance with the agreement. The lucky former partner may be paid out in full on retirement, leaving no financial or business connection. Many partnership agreements, however, contemplate a payout period such as a lump sum with, say, the balance paid over equal installments of four years, with or without interest.

As an alternative, partnership agreements may allow for pension payments, crystalised and determined on the date of retirement, varied only by say the CPI or similar.

Whatever the mechanism above, once set the retired partner simply receives the predetermined payments over the predetermined time period, with no rights to vary, renegotiate or settle early.

Such payments are quite typical situations for former partners to find themselves in and, if calculated and paid as outlined above, do not constitute a breach of independence under s324CF(7).

Given the above typical situations, the question arose in my case, what particular relationships might attach to s324CF(7)(c). After all, the question was asked, were not amounts paid out by pension or periodic payments rights in relation to the termination of, or the value of, the person's former partnership interest in the firm? Whereas (d) and (e) appeared to give me a clean bill of health, I was not convinced that I was not to be caught by (c) and be found not to be independent.

CONCLUSIVE ANSWERS

Seeking to obtain conclusive answers which differentiated between the different sections, or to explain (c) in a satisfactory manner, I made general enquiries of both

© The Australian Professional Joint Accounting Bodies

the Institute and ASIC.

In the circumstances I obtained legal advice as to the operation of s324CF(7)(c) as it may pertain to my circumstances. I am indebted to Neil Fearis of Minter Ellison for the advice provided and have attempted to precis it below.

In the first instance it was considered undeniable that the payments being made to me give me certain rights against my former firm "in relation to the termination of … [your] former partnership interest in the firm". However, it is clear equally that those rights do not relate to the value of your former partnership interest, in the sense that the value of that interest was fixed and monetised at the time of retirement, and thus the value of the interest no longer has any bearing on your rights against the firm as an unpaid creditor.

It was said to be evident that the mischief at which the legislation is aimed is arrangements under which the former member of the firm has a continuing interest in the financial success of the firm such as might compromise his or its independence were he to be appointed as a director of one of the firm's audit clients.

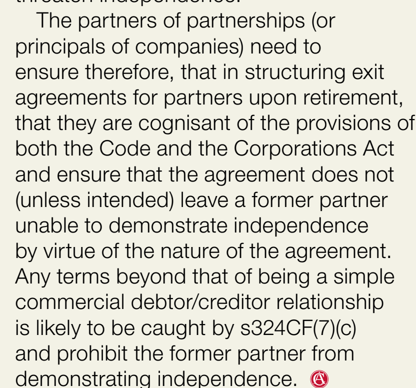
It was pointed out that in the *Report on the Independence of Australian Company Auditors* prepared by Professor Ian Ramsay, it was specifically recommended that an audit firm be treated as not independent if a former partner of the firm becomes a director of the firm's audit clients unless the former partner, among other things, "has no capital balances in the … firm". It is this recommendation which would appear to have been enacted in s324CF(7)(c).

It may be that the Ramsay Report's reference to capital balances which a former partner may have in the firm was intended to cover situations where the former partner has left his capital in the firm, and that gives him residual rights against the firm and/or his former partners (eg as to payment of interest on that capital).

Despite the common circumstance relating to former partners being to crystalise all amounts owing (as described previously) into a debt owing and being paid off over time (or in the form of a pension), the debt is undeniably related to the partner's retirement, but that any rights which exist are purely that of an unpaid creditor, with no continuing financial interest in the firm beyond that of a creditor. It was concluded that s324CF(7)(c) should be read down so as not to extend to rights of this nature.

It would seem clear by both its intention, as well as the above discussion based on legal advice provided, that s324CF(7)(c) operates separately to s324CF(7)(d) to catch a situation whereby a former partner has retained by way of capital or other means, some latent rights against his old firm which extend beyond those of a mere creditor.

The Institute has confirmed their interpretation of APES 110 Section 290 paragraph 290.144, which is closely aligned to s324CF(7). The safeguard of an individual's rights is considered to be very specific and not intended to capture all potential legal rights. Further, the effective carve out of the financial arrangements in Para 290.144 (of regular payments of a fixed pre-determined dollar amount which is not dependent, directly or indirectly, on the revenues, profits or earnings of the firm or of a dollar amount where the method of calculating the dollar amount is fixed and is not dependent, directly or indirectly, on revenues, profits or earnings of the firm) does not limit a former partner's rights in relation to those financial arrangement. Once carved out, the former partner's rights in relation to those financial arrangements does not vary the nature of the carve out, and consequently does not threaten independence.



The partners of partnerships (or principals of companies) need to ensure therefore, that in structuring exit agreements for partners upon retirement, that they are cognisant of the provisions of both the Code and the Corporations Act and ensure that the agreement does not (unless intended) leave a former partner unable to demonstrate independence by virtue of the nature of the agreement. Any terms beyond that of being a simple commercial debtor/creditor relationship is likely to be caught by s324CF(7)(c) and prohibit the former partner from demonstrating independence.

Geoff Brayshaw FCA is the retired managing partner of BDO in Western Australia and a past president of the Institute.

© The Australian Professional Joint Accounting Bodies

MAKING THE HARD DECISIONS

➤ DR GORDON WOODBINE

WHAT ISSUES ENCOURAGE ACCOUNTANTS AND AUDITORS TO BE LOYAL AGENTS WHEN FACED WITH AN ETHICAL DILEMMA?

Imagine yourself as an accountant or auditor employed within the risk management department of a large publicly listed financial institution, where you had access to much personal and confidential information about its business clients. You are part of an elite group of specialists who help inform management how best to organise and invest its assets.

Over time you discover that your colleagues are involved in an insider trading scheme, which allows them to make use of available information for personal gain. They insist their scheme is harmless in that the information is simply used to help them in a joint investment program and none of the confidential facts are sold or transferred to other parties. They trust you enough to invite you to invest in their program. What would you do?

The casual observer would likely conclude that Australian accountants and auditors are, on the whole, loyal agents, who can be trusted to act in the best interests of employers. During the last few months, a large number of Australian accountants and auditors were invited to go online and read a fairly detailed scenario which posed the dilemma described above. They were asked to rate the likelihood of their advising management about the existence of the unethical work practice if they were the officer involved, using a seven point scale ranging from 1 – "Definitely advise management" to 7 – "Definitely not advise management". Interestingly, the preliminary sample was weighted by the presence of a large number of mature, experienced and well-qualified managers and supervisors, who on average scored around 2 on the scale. When asked to indicate what factors influenced the moral choices they made, subjects listed the reasons shown in Table 1. These include negative as well as positive influences and the accompanying ratings indicate the average strength of the influence (where 7 is the maximum).

Of course, when making a moral choice about how to act each respondent would not have considered every issue. In fact, they probably had time to consider only a small number, based on how they viewed the issues, their sensitivity to them and their ability to reason through the consequences of

© The Australian Professional Joint Accounting Bodies

their likely actions. And their own work situation may be quite dissimilar to that of the hypothetical scenario. One detail that all survey respondents have in common with the chief character in the scenario, however, is that they are all moral agents, trusted to always apply themselves conscientiously and to use their specialised skills and abilities in a way that maximises the interests of all affected parties.

The fact that all of us at some time or other fail to attain these lofty expectations is a function of what is termed an "agency problem". When left unsupervised, business agents can be tempted to shirk their responsibilities and misuse information or knowledge relating to work responsibilities. Thankfully, most of our indiscretions are minor and as professionals we would aspire to avoid them. Nonetheless, the problem persists and we are occasionally required to take moral inventory and reassess where we stand on various issues.

HOW DO AGENCY ISSUES INFLUENCE MORAL CHOICE?

Despite the apparently good results reported in this preliminary survey, there are issues that act to cloud performance. In this instance, multivariate statistical analysis helped to provide additional insights into the ethical predispositions of the respondents, based on the assumption, that as moral agents, they were to varying degrees concerned about the stakeholders they serve as well as the impact their choices had on their own careers and reputations. The data indicates that respondents fell into three distinct motivational groupings, based on concerns about various stakeholders and their individual self-interest. These groupings, or typologies, are illustrated in Figure 1 (on page 26) and are somewhat distinct and definable.

TABLE 1 WHETHER OR NOT TO REPORT UNETHICAL WORK PRACTICE

Factors influencing moral choice	Average strength of influence (1 = least, 7 = most)
1. Temptation to join co-workers in the insider trading scheme	1.75
2. Loyalty to workmates (with whom he worked closely and who had given him a very generous wedding gift)	2.13
3. The undisclosed self-incriminating information (previous drug offence) which might be discovered following bank investigationw	2.49
4. Concern about shame (e.g. dishonour to father who was well respected in banking sector) and loss of face that might occur	2.68
5. Concern about the effect his disclosure of the unethical activity might have on his personal reputation/career	3.65
6. Concern about how the disclosure of the unethical activity might impact the way shareholders, investors and the general public view the bank (i.e. public interest)	3.99
7. Concern about the possibility that his failure to report or delay the reporting of the activity would reflect on him as others may eventually uncover the insider trading scheme	4.23
8. Social accountability element. How the bank officer might view the importance of protecting other employees who were subject to this kind of dilemma (in this scenario the bank had no whistleblower protection policies)	4.53
9. Desire to protect bank management from the growth of unethical work practices amongst its employees	4.82
10. Obligation to the accounting profession and its associated codes of conduct	4.93
11. Personal perception about the gravity of issue (i.e. morality of insider trading)	5.32
12. Extent to which the decision was guided by a personal conviction (religious or otherwise) about what is right and wrong	5.60

Three groupings were distinguished within the sample. The majority of respondents were classified as either altruists or highly disguised self-interest grouping. Altruists are agents who place others before self-interest in every situation, regardless of the circumstances. The fact that over half of the respondents joined this grouping is partly dependent on the nature of the dilemma (not considered highly concerning in this instance) and partly on the pattern of moral thinking that they applied to the problem. The average response score for this group is respectfully low (1.62 out of 7). In this instance, altruists were strongly inclined to report the insider trading scheme to management.

The average score for respondents belonging to the highly disguised self-interest group is also equally low (1.63). In figure 1, these persons are identified as being equally

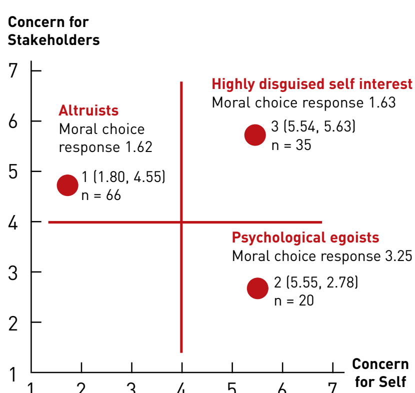
© The Australian Professional Joint Accounting Bodies

concerned with the interests of others as well as themselves. In this study, the participants on average were strongly inclined to advise management, which is to be expected given the general profile of the respondent and the nature of the dilemma. In a related study conducted elsewhere, however, respondents showed an inclination to change allegiances when the moral dilemma intensified, suggesting a desire to protect their own interest first, hence the term 'disguised self interest'.

Of greatest interest and concern is that group which places self-interest before the interests of stakeholders. These psychological egoists scored an average of 3.25, significantly greater than members of the other groups and an indication of the potential for inappropriate agent activity.

It is acknowledged that the sample used in this investigation is somewhat biased, to the extent that it included a relatively high proportion of experienced and well-qualified leaders. Other research suggests that employees in this category are less likely to be averse to risk. For example, they are less likely to be put off by the possible repercussions they might envisage from blowing the whistle (to management in this instance). Their moral choices would therefore tend to reflect these perceptions. Younger, less stable and financially secure members of the profession are likely to be concerned about their reputations and careers and more susceptible to avoiding the risks connected with internal whistle blowing (in the scenario the institution had no internal arrangements in place to protect employees).

FIGURE 1 MOTIVATIONAL TYPES



WE ARE OCCASIONALLY REQUIRED TO TAKE MORAL INVENTORY AND REASSESS WHERE WE STAND ON VARIOUS ISSUES.

THE INDIVIDUAL MINDSET

Closer analysis of subject responses disclosed further revealing information about the psyche of members attached to each of the three groups referred to above. Firstly, both altruists and persons exhibiting highly disguised self-interest indicated particular concern about the gravity of the issue (insider trading) and placed importance on the shame and dishonour their perceived involvement in the scheme might bring to them and their families. Members of the egoist group, however, displayed no such inclinations. In fact, their inclinations were decidedly more venal or morally reprehensible in the sense that they indicated a greater interest in joining their colleagues in the reportedly profitable scheme. They also indicated higher levels of loyalty towards their colleagues and were more inclined to consider delaying the reporting of the scheme to management.

These admittedly negative preferences are part of the package of moral hazards facing agents in the workplace and reflect a degree of what the Greek theologian Evagrius of Pontus – the originator of the seven deadly 'sins' – referred to as "an abnormal obsession with self". Selfishness needs to be replaced by selflessness, which requires an understanding of, as well as and empathy towards, the needs of the various stakeholders affected by the actions and decisions accountants and auditors as moral agents are required to make. Selflessness is the key ingredient that encourages accountants to be loyal agents.

FOSTERING BETTER BEHAVIOUR

This study demonstrates that most Australian accountants have strong convictions about the gravity of unethical practices like insider trading schemes and that such practices should not be condoned. However, as business agents, quite often

© The Australian Professional Joint Accounting Bodies

what they believe does not translate into appropriate moral behaviour. The agency problem can affect the decisions accountants make and their identifiable connection with particular motivational types or groups acts to influence the actions they take. It is a matter of aligning with the right groups – putting others first.

What can be done to improve performance in this important area of concern? Can individuals, employers or external agencies make a difference? These matters will be discussed in a further article. The Australian survey described here included the collection of data relating to a respondent's workplace, the pervading ethical climate and the extent to which programs and policies promoting ethical practices had been implemented. Whether these external factors had an impact on the moral choices of respondents will also be discussed later. **NA**

SELFLESSNESS IS THE KEY INGREDIENT THAT ENCOURAGES ACCOUNTANTS TO BE LOYAL AGENTS.

Dr Gordon Woodbine is a research fellow and senior lecturer with the School of Accounting, Curtin University of Technology, Western Australia, with over 20 years' experience at a number of educational institutions in Australia and overseas. His research interests include business ethics and governance, education and auditing. He may be contacted by email at gordon.woodbine@cbs.curtin.edu.au.

© The Australian Professional Joint Accounting Bodies

8. Appendices

Appendix 1 – Sample inter-firm independence declaration

Following is a sample declaration format that may be provided in respect of entities that are material to a parent entity, where that parent entity has Australian reporting requirements. Note: This confirmation does not cover SEC or other jurisdictions' independence requirements.

Dear Sirs,

[*Insert Name of company/entity*]

We have [audited/reviewed as appropriate] the financial statements of [*Name of company/entity*] (a subsidiary/investee of [*Name of parent entity/parent company*] ('parent entity') for the financial period ended [*insert half-year or year-end date*]. As you will report on the consolidated financial statements of parent entity for the period ended [*insert half-year or year-end date*], we furnish you with the following information for the period covered by our engagement and our [auditor or reviewer as appropriate] report:

Independence

I confirm that:

[*Firm name*] ('the firm') is independent with respect to [*Name of company/entity*] and its controlled entities in accordance with APES 110 *Code of Ethics for Professional Accountants*, Section 290 Independence – Assurance Engagements and the auditor independence requirements of the *Corporations Act 2001*, as applicable. In particular:

Neither the firm, nor any partners or professional staff members who are members of the audit team nor any managerial (or above) staff members who provide more than 10 hours of non-audit services to [*Name of company/entity*], nor their immediate family members, have any direct or material indirect financial interest in [*Name of company/entity*].

Neither the firm nor members of the [*Name of company/entity*] audit team, nor their immediate family members, owe any amount to [*Name of company/entity*]'s unless that amount arose in the ordinary course of business in accordance with *[Name of company/ entity*]'s normal terms and conditions.

Any non-audit services provided to [*Name of company/entity*] have been performed in accordance with the applicable auditor independence requirements as set out above.

There are no business relationships between our firm and [*Name of company/entity*] which may reasonably be thought to bear on independence.

To the best of our knowledge, there are no other relationships, circumstances or conflict of interest situations which could be thought to bear on our independence with respect to [*Name of company/entity*].

[*FIRM NAME*]

[*Partner name*]

[*Date*]

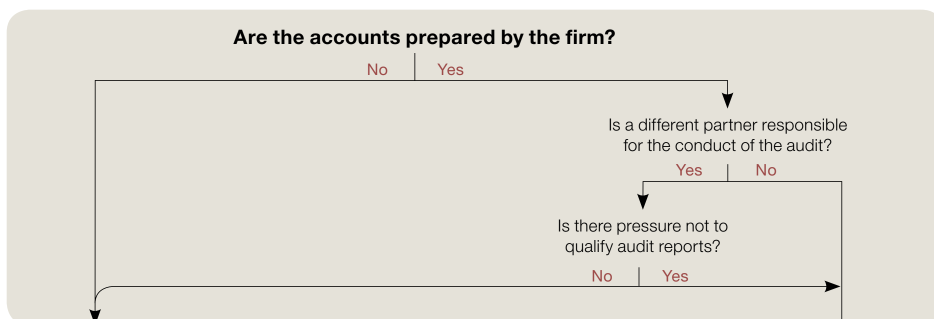
	Amount $

© The Australian Professional Joint Accounting Bodies

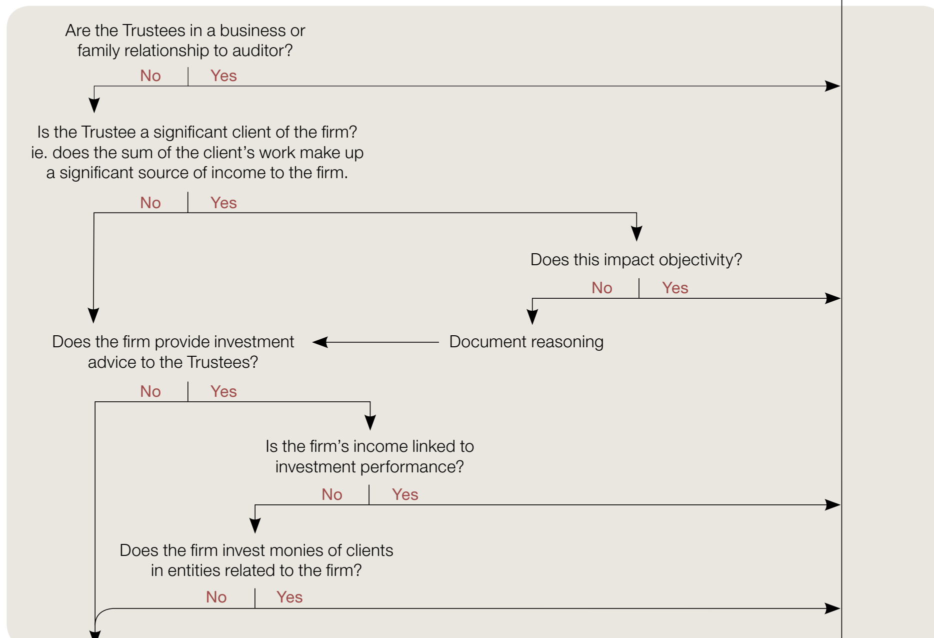
Appendix 2 – Decision tree for SMSFs

Identify threats

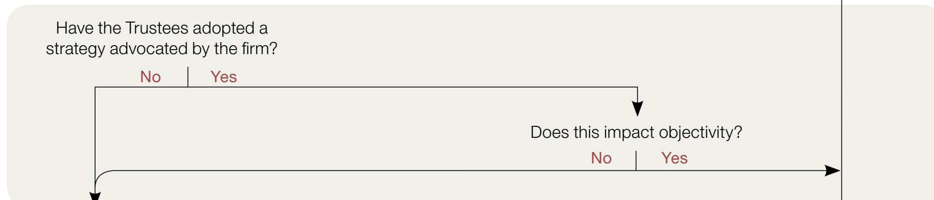
Self Review Threat



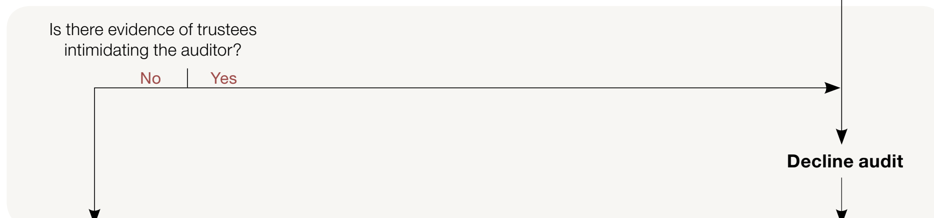
Self Interest Threat



Advocacy Threat



Intimidation Threat



No threats identified

Outsource audit to another firm. Put in place safeguards to address threat.

© The Australian Professional Joint Accounting Bodies

Appendix 3 – Key reference material

It is important to remember that this is a guide for accountants and auditors. For more detailed information, you should refer to the source materials.

Professional Standards

APES 110 Code of *Ethics for Professional Accountants* Section 290	F.1 was reissued on 1 July 2006 as Section 290 of APES 110 and is now the mandatory independence standard for all members of the professional accounting bodies.
Additional Guidance on F.1 implementation issues drawn from IFAC Interpretation 2003-01	In 2003 the IFAC Ethics Committee issued interpretations of the IFAC Code when particular questions were raised by members that had broad implications. The interpretations are authoritative and addressed the transition arrangements relating to the provision of non-assurance services to assurance clients and lead engagement partner rotation for audit clients that are listed entities. The Institute and CPA Australia issued additional guidance drawn from that IFAC Interpretation applicable to the transitional period following implementation (31 December 2003) or early adoption of the F.1 Statement. This has now been replaced by the Section 290 Interpretations of APES 110.

Legislation

***Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure)* Act 2004 (Cwlth) (CLERP 9)**	Received Royal Assent on 30 June 2004. The Act amends a number of Acts, including the *Corporations Act 2001*.
Corporations Amendment Regulations 2006 (No. 4)	These Regulations clarified amendments to reflect the intent of the CLERP 9 auditor independence amendments: • The introduction of an ordinary course of business exemption in relation to the prohibition on an audit firm owing more than $5000 to an audit client • Clarification that cheques and savings accounts are not intended to be covered by the prohibition on loans by an audit firm to the audit client • Giving ASIC the power to extend the period within which an auditor is required to resolve a conflict of interest situation beyond the existing 21 days under subs. 327(2A), 327(2B) and 327(C) of the Act.
Corporations Legislation Amendment (Simpler Regulatory System) Act 2007	Received Assent on 28 June 2007. The Act amends the law relating to corporations, and for related purposes.
Explanatory Memorandum to CLERP 9 Bill	The Explanatory Memorandum provides an insight into the intention behind a particular section of the Act or Regulation and how it is intended to operate. Despite the significance of these documents in understanding the regime, it is important to note that Explanatory Memoranda/Statements are issued by the Government and are not legally enforceable. They are the Government's interpretation of the regime and how it should operate in practice.
ASIC Regulatory Guide	ASIC has issued a relevant regulatory guide, which indicates ASIC's interpretation of the legislation and a guide to how it intends to regulate. This is Regulatory Guide 187 Auditor Rotation (RG 187).

Prudential Standard

APS 510 Governance	The key requirements of this prudential standard issued by the Australian Prudential Regulation Authority (APRA) include certain provisions dealing with independence requirements for auditors consistent with those in the *Corporations Act 2001* and apply to authorised deposit-taking institutions.

© The Australian Professional Joint Accounting Bodies

Printed on Precision – an Australian made paper resource.

Contact details

CPA Australia

Level 28, 385 Bourke Street
Melbourne VIC 3000

GPO Box 2820
Melbourne VIC 3001

Phone 61 3 9606 9606
Fax 61 3 9670 8901
Email cpaonline@cpaaustralia.com.au

cpaaustralia.com.au

The Institute of Chartered Accountants in Australia

33 Erskine Street
Sydney NSW 2000

GPO Box 3921
Sydney NSW 2001

Service 1300 137 322
Phone 02 9290 1344
Fax 02 9262 1512
Email service@charteredaccountants.com.au

charteredaccountants.com.au

National Institute of Accountants

Level 6, 555 Lonsdale Street
Melbourne VIC 3000

PO Box 1637
Melbourne VIC 3001

Phone 61 3 8665 3100
Fax 61 3 8665 3130
Email natoffice@nia.org.au

www.nia.org.au