

## **APPENDIX G**

### **IFAC EXPOSURE DRAFT**

This re-exposure draft has been drafted by the Ethics Committee of the International Federation of Accountants and was approved for publication in April 2001. The exposure draft may be modified in the light of comments received before being issued in its final form.

*Comments should be submitted in writing so as to be received by June 30, 2001 preferably by e-mail, or on a computer disk or in writing. Unless respondents to the exposure draft specifically request confidentiality, their comments are considered a matter of public record. Comments should be addressed to:*

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The approved text of this Exposure Draft of the Ethics Committee is published in the English language.

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## PREFACE

### INTRODUCTION

In June 2000, the IFAC Council (now the IFAC Board) approved, for publication, the exposure draft *Independence – Proposed Changes to the Code of Ethics for Professional Accountants*. The Ethics Committee has considered the comments received on exposure and has released this re-exposure draft. Although there have been no significant changes in principle, the document has been substantially re-written in response to comments received. In particular, the re-exposure draft clarifies certain points and describes additional specific circumstances that may create threats to independence and safeguards that may be appropriate to reduce the threats to an acceptable level in each circumstance. Therefore, this document is being re-exposed to provide interested parties with the opportunity to comment on the changes made.

### HIGHLIGHTS OF RE-EXPOSURE DRAFT

The June 2000 exposure draft proposed a move to a conceptual framework approach that would require the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level. Respondents to the exposure draft were strongly supportive of this approach and suggested that additional examples be added. Therefore, the re-exposure draft provides details of additional circumstances that may create threats to independence. As with the exposure draft, in certain circumstances the only possible course of action is to resign or not accept the assurance engagement.

The June 2000 exposure draft was predicated on the assumption of the issuance of the new International Standard on Assurance Engagements and, therefore, used the term “reporting accountant”. The new assurance standard has now been issued but it does not use the term “reporting accountant”. The re-exposure draft, therefore, uses the term “assurance team”.

In response to comments received on exposure, the re-exposure draft expands the class of people that may create threats to independence. As with the exposure draft, immediate and close family members may create threats to independence; however, the re-exposure draft also discusses threats to independence that may be created by individuals who are not part of the assurance team such as other partners and professional staff within the firm, and the firm itself.

Many respondents indicated the importance of consistency between jurisdictions. In considering revisions to the exposure draft, the Ethics Committee carefully considered this matter, and, where appropriate took steps to achieve greater consistency.

### REQUESTS FOR COMMENTS

While comments are sought on all matters addressed in this re-exposure draft, the Ethics Committee would particularly welcome comments on an appropriate effective date for this section.

The Ethics Committee looks forward to receiving comments on this re-exposure draft from all interested parties. Respondents are invited to provide detailed comments indicating specific paragraph numbers, or groups of paragraphs to which they relate, clearly explaining the issue and suggesting alternative wording, with supporting reasoning, where appropriate. These comments should be submitted in time to be received by **June 30, 2001**. Unless respondents request confidentiality, their comments will be a matter of public record.

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## Extract from definitions section of code of ethics:

|                             |  |
|-----------------------------|--|
| Audit client                | An entity in respect of which a firm conducts an audit engagement. When the audit client is a listed entity, audit client includes its related entities.   |
| Audit engagement            | An assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing. This includes a Statutory Audit which is an audit required by national legislation or other regulation.  |
| Assurance client            | An entity in respect of which a firm conducts an assurance engagement.   |
| Assurance engagement        | An engagement conducted to provide a high or a moderate level of assurance that the subject matter conforms in all material respects with identified suitable criteria. This would include an engagement in accordance with the “International Standard on Assurance Engagements” issued by the International Auditing Practices Committee or in accordance with specific standards for assurance engagements issued by the International Auditing Practices Committee such as an audit or review of financial statements in accordance with International Standards on Auditing.  |
| Assurance team              | <p>(a) All professionals participating in the assurance engagement; and</p> <p>(b) All others within a firm who can directly influence the outcome of the assurance engagement, including:</p> <ul style="list-style-type: none"> <li>• those who supervise or have direct management responsibility for the assurance engagement, for the purposes of an audit engagement this includes those at all successively senior levels through the firm’s chief executive;</li> <li>• those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement;</li> <li>• those who provide quality control for the assurance engagement; and</li> <li>• those who provide direct supervisory, management, compensation or other oversight of the assurance engagement partner.</li> </ul> |
| Close family                | A parent, non-dependent child or sibling.  |
| Direct financial interest   | A financial interest beneficially owned directly by and under the control of an individual (including those managed on a discretionary basis by others).   |
| Directors and officers      | Persons charged with the governance of an entity, regardless of their title, which will vary from country to country.  |
| Financial interest          | An interest in equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.  |
| Firm                        | <p>(a) A sole practitioner, partnership or corporation of professional accountants that performs an assurance engagement;</p> <p>(b) An entity that controls such parties; and</p> <p>(c) An entity controlled by such parties or otherwise under common control, ownership or management, or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm.</p>  |
| Immediate family            | A spouse (or equivalent) or dependent.   |
| Indirect financial interest | A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual has no control.   |
| Independence                | <p>Independence is:</p> <p>(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that impair professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and</p>   |

- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional skepticism had been unacceptably impaired.

|                                |   |
|--------------------------------|---|
| Lead engagement partner        | In connection with an audit, the partner responsible for signing the report on the consolidated financial statements of the audit client, and, where relevant, the partner responsible for signing the report in respect of any entity whose financial statements form part of the consolidated financial statements, and on which a separate stand-alone report is issued. When no consolidated financial statements are prepared, the lead engagement partner would be the partner responsible for signing the report on the financial statements.  |
| Listed entity                  | An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.   |
| Other client service personnel | Partners and managerial employees who provide non-assurance services to an audit client, except those whose time involvement is clearly insignificant.  |
| Office                         | A distinct sub-group, whether organized on geographical or practice lines, in which the lead engagement partner practices in connection with the audit.   |
| Related entity                 | <p>(a) An entity that has direct or indirect control over the assurance client provided the assurance client is material to such entity;</p> <p>(b) An entity with a direct financial interest in the assurance client provided that such entity has significant influence over the assurance client and the interest in the assurance client is material to such entity;</p> <p>(c) An entity over which the assurance client has direct or indirect control;</p> <p>(d) An entity in which the assurance client has a direct financial interest, provided the assurance client has significant influence over such entity and the interest is material to the assurance client; and</p> <p>(e) An entity which is under common control with the assurance client (hereinafter a “sister entity”) provided the sister entity and the assurance client are both material to the entity that controls both the assurance client and sister entity.</p> |

## Draft Revision to Section 8 of the IFAC Code of Ethics

### INDEPENDENCE

- 8.1 It is in the public interest and, therefore, required by this Code of Ethics, that the firm and the assurance team be independent of the assurance client.
- 8.2 Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. “The International Standard on Assurance Engagements” issued by the International Auditing Practices Committee describes the objectives and elements of assurance engagements to provide either a high or a moderate level of assurance. The International Auditing Practice Committee has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements.

Paragraphs 8.3-8.6 are taken from the “International Standard on Assurance Engagements” and describe the nature of an assurance engagement.

- 8.3 Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements:
- (a) a three party relationship involving:
    - (i) a professional accountant;
    - (ii) a responsible party; and
    - (iii) an intended user;
  - (b) a subject matter;
  - (c) suitable criteria;
  - (d) an engagement process; and
  - (e) a conclusion.
- The responsible party and the intended user will often be from separate organizations but need not be. A responsible party and an intended user may both be within the same organization, for example, a governing body may seek assurance about information provided by a component of that organization. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement.
- 8.4 There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:
- Engagements to report on a broad range of subject matters covering financial and non-financial information;
  - Attest and direct reporting engagements;
  - Engagements to report internally and externally; and
  - Engagements in the private and public sector.
- 8.5 The subject matter of an assurance engagement may take many forms, such as the following:
- Data (for example, historical or prospective financial information, statistical information, performance indicators);
  - Systems and processes (for example, internal controls);
  - Behavior (for example, corporate governance, compliance with regulation, human resource practices).
- 8.6 Not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include the following:
- Agreed-upon procedures;
  - Compilation of financial or other information;
  - Preparation of tax returns where no conclusion is expressed, and tax consulting;
  - Management consulting; and
  - Other advisory services.
- 8.7 This section of the Code of Ethics (this section) provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that the firm and

the assurance team should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. This section is not a set of fixed rules and does not seek to identify all circumstances that may create threats to independence. This section requires the firm and the assurance team to apply the principles to the particular circumstances under consideration. Consequently, it is not sufficient for a firm or an assurance team merely to comply with the examples presented.

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

#### 8.8 Independence requires:

##### (a) Independence of mind:

The state of mind that permits the provision of an opinion without being affected by influences that impair professional judgment; allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

##### (b) Independence in appearance:

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been unacceptably impaired.

- 8.9 Use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has some dependency on, and relationships with, others. Therefore, the significance of economic and financial relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be acceptable.
- 8.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules, which may be arbitrary, is, therefore, in the public interest.
- 8.11 This section is based on such a conceptual approach, one that takes into account threats to independence, accepted safeguards and the public interest. Under this approach, firms and members of assurance teams have an obligation to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the firm, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client may create threats to independence.
- 8.12 This section applies to all assurance engagements. However, the nature of the threats and the applicable safeguards necessary to reduce the threats to an acceptable level may differ depending on whether the report is an audit report or an other type of assurance report, and the purpose, subject matter and intended users of the report. A firm should, therefore, evaluate the relevant circumstances and the nature of the assurance engagement in deciding whether it is appropriate to accept or continue an engagement, the nature of the safeguards required and whether a particular individual should be a member of the assurance team.
- 8.13 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, a member of the assurance team and the assurance client. Where relevant to the evaluation, consideration should be given to threats created by such interests and relationships that may exist between the firm, a member of the assurance team and related entities.
- 8.14 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. An inadvertent violation of independence principles would not impair the independence of a firm or an assurance team provided the firm has policies and procedures in place and, once discovered, the violations are corrected promptly.
- 8.15 Throughout this section, reference is made to significant and clearly insignificant in the evaluation of threats to independence. In considering the significance of any particular matter, qualitative and well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

### Objective and Structure of this Section

- 8.16 The objective of this section is to assist firms and assurance teams in:
- (a) identifying threats to independence;
  - (b) evaluating whether these threats are clearly insignificant; and
  - (c) in cases, when the threats are not clearly insignificant, identifying and applying appropriate safeguards to reduce the threats to an acceptable level.
- In situations where 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.
- 8.17 This section outlines the threats to independence (paragraphs 8.25 – 8.30). It then analyzes safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraphs 8.31 – 8.39). It concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships and the safeguards that may be appropriate to eliminate these threats or reduce them to an acceptable level (paragraphs 8.100 onwards). The examples are not intended to be all-inclusive.
- 8.18 When a firm identifies threats to independence, that are not clearly insignificant, and decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to reduce the threats to an acceptable level.
- 8.19 Certain paragraphs in this section deal with additional matters that are relevant to the audit of listed entities. The financial arrangements of such entities are frequently complex and they have a large number of shareholders for whom the audit report represents an important part of the information used to assess the entity's financial performance and position. Furthermore, most of the larger companies whose performance can have a perceptible effect on national economies are listed entities. There is, therefore, a strong public interest in the financial statements of listed entities. This interest is reflected in their governance structures, which are sophisticated and enable a wide range of safeguards to be applied. In determining appropriate safeguards to be applied, due attention should be paid to threats to the appearance of independence. Accordingly, it is appropriate that more specific guidance be given in relation to the audit of listed entities, where relevant.
- 8.20 In some cases, there may also be significant public interest in entities which are not listed entities and consideration should be given to the application of the principles set out in this section in relation to the audit of listed entities to such other audit clients.

### National Perspectives

- 8.21 This section establishes a conceptual framework for independence requirements for assurance engagements that is the international standard on which national standards should be based. Accordingly, no member body or firm is allowed to apply less stringent standards than those stated in this section.
- 8.22 Certain examples in this section indicate how the principles are to be applied to listed entity audit engagements. When a member body chooses not to differentiate between listed entity audit engagements and other audit engagements, the examples that relate to listed entity audit engagements should be considered to apply to all audit engagements. Member bodies and firms should apply this section unless they are prohibited from complying with certain parts of it by law or regulation. In such cases, they should comply with all other parts of this section.
- 8.23 When an assurance team conducts an assurance engagement, in accordance with the "International Standard on Assurance Engagements" or with specific standards for assurance engagements issued by the International Auditing Practices Committee such as an audit or review of financial statements in accordance with International Standards on Auditing, the assurance team and the firm should comply with this section unless they are prohibited from complying with certain parts of this section by law or regulation. In such cases, the assurance team and the firm should comply with all other parts of this section.
- 8.24 Some countries and cultures may have set out, either by legislation or common practice, more specific definitions of relationships than those used in this section. For example, some national legislators or regulators may have prescribed lists of individuals who should be regarded as close family.

### Threats to Independence

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

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

- (a) a direct financial interest or material indirect financial interest in an assurance client or a related entity;
- (b) a loan to or from an assurance client or any director, officer or controlling owner of an assurance client;
- (c) fear of losing the engagement;
- (d) undue dependence on total fees from an assurance client;
- (e) having a close business relationship with an assurance client;
- (f) potential employment with an assurance client; and
- (g) contingent fees relating to assurance engagements.

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

Examples of circumstances that may create a self-review threat include, but are not limited to:

- (a) a member of the assurance team being, or having recently been, a director or officer of the assurance client;
- (b) a member of the assurance team being, or having recently been, an employee of the assurance client in a position to affect the subject matter of an assurance engagement;
- (c) performing services for an assurance client that directly affect the subject matter of an assurance engagement; and
- (d) preparation of original data used to generate financial statements or preparation of other records that are the subject matter of an assurance engagement.

A self-review threat may arise in relation to non-assurance services provided by a firm that are subsequently reviewed as part of a non-audit assurance engagement. Consideration should be given to the significance of the firm’s involvement with the subject matter and whether any identified threats to independence could be reduced to an acceptable level by the application of safeguards, or whether the engagement should be declined. When the non-assurance services are not related to the subject matter of the non-audit assurance engagement, the threats to independence will generally be insignificant.

8.28 “Advocacy Threat” occurs when a firm, or a member of the assurance team, becomes an advocate for or against an assurance client’s position or opinion to the point that objectivity is, or is perceived to be, impaired.

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

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

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

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

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

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

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

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

### **Safeguards**

- 8.31 The firm and the assurance team have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to reduce the threats to an acceptable level.

- 8.32 When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to reduce the threats to an acceptable level. This decision should be documented. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be acceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of a firm.

- 8.33 Safeguards fall into three broad categories:

- (a) safeguards created by the profession, legislation or regulation;
- (b) safeguards within the assurance client; and
- (c) safeguards within the firm’s own systems and procedures.

The firm and the assurance team should select appropriate safeguards to reduce threats to independence, other than those that are clearly insignificant, to an acceptable level. The first two categories of safeguards are not within a firm’s control. Therefore, when such safeguards are not strong the firm should implement effective safeguards within the firm itself.

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

- (a) educational, training and experience requirements for entry into the profession;
- (b) continuing education requirements;
- (c) professional standards and monitoring and disciplinary processes;
- (d) external review of a firm’s quality control system; and
- (e) legislation governing the independence requirements of the firm.

- 8.35 Safeguards within the assurance client, include the following:

- (a) when the entity’s management appoints the firm, persons other than management ratify or approve the appointment;
- (b) the employment of high-quality staff in sufficient numbers to ensure that a member of the assurance team would not be requested to make managerial decisions for the entity;
- (c) internal procedures ensuring objective choice in commissioning non-assurance engagements; and
- (d) a corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm’s services.

- 8.36 Audit committees have an important corporate governance role in that they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships that might, in the firm’s opinion, reasonably be thought to bear on independence.

- 8.37 Firms should establish policies and procedures relating to independence communications with audit committees. In the case of the audit of listed entities, the firm should communicate orally, and in writing at least annually, all relationships between the firm and the audit client that in the firm’s professional judgement 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.

8.38 Safeguards within the firm's own systems and procedures include the following:

Firm-wide safeguards:

- (a) firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
- (b) policies and procedures to monitor and implement quality control of assurance engagements;
- (c) documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to reduce the threats, other than those that are clearly insignificant, to an acceptable level;
- (d) internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence and quality control;
- (e) policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
- (f) policies and procedures to prohibit individuals who are not part of the assurance team from influencing the outcome of the assurance engagement;
- (g) timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including regular training and education thereon;
- (h) means of advising partners and professional staff of those assurance clients and related entities from which they must be independent; and
- (i) policies and procedures to empower staff to communicate, to senior levels within the firm, any issue of independence and objectivity that concerns them; this includes informing staff of the procedures open to them.

Engagement specific safeguards:

- (a) involving an additional professional accountant to carry out reviews of the work done or otherwise advise as necessary. This individual could be someone from outside the firm, or someone within the firm who is not a member of the assurance team;
- (b) consulting a third party, such as a committee of independent directors, a professional regulatory body or another professional accountant;
- (c) rotation of senior personnel;
- (d) discussing independence issues with the audit committee or others charged with governance;
- (e) disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;
- (f) policies and procedures to monitor, and if necessary restrict, the magnitude of revenue received from a single assurance client;
- (g) policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client; and
- (h) removing an individual from the assurance team, where that individual's financial interests or relationships create a threat to independence.

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

8.40 This section is applicable to assurance engagements for periods commencing on or after \_\_\_\_\_, earlier application is encouraged.

**APPLICATION OF PRINCIPLES TO SPECIFIC SITUATIONS****Index**

| <b>Subject</b>   | <b>Paragraph</b> |
|--|------------------|
| Introduction   | 8.100            |
| Financial interests  |                  |
| Financial interests in an assurance client   | 8.101 – 8.113    |
| Loans and guarantees   | 8.114 – 8.118    |
| Close business relationships with an assurance client                                    | 8.119 – 8.121    |
| Family and personal relationships  | 8.122 – 8.127    |
| Employment with an assurance client  | 8.128 – 8.130    |
| Recent service with an assurance client  | 8.131 – 8.133    |
| Serving as an officer or as a director on the board of an assurance client               | 8.134 – 8.137    |
| Long association of senior personnel with an assurance client                            | 8.138 – 8.139    |
| Provision of non-assurance services to an assurance client                               | 8.140 – 8.147    |
| Preparing accounting records and financial statements                                    | 8.148 – 8.156    |
| Valuation services   | 8.157 – 8.160    |
| Internal audit services  | 8.161 – 8.165    |
| IT systems services  | 8.166 – 8.169    |
| Temporary staff assignments  | 8.170            |
| Acting for or assisting an assurance client in the resolution of a dispute or litigation | 8.171 – 8.176    |
| Legal services   | 8.177 – 8.183    |
| Recruiting senior management for an assurance client                                     | 8.184            |
| Corporate finance and similar activities   | 8.185 – 8.186    |
| Fees and pricing   |                  |
| Fees – Relative size   | 8.187 – 8.188    |
| Fees – Overdue   | 8.189            |
| Pricing  | 8.190            |
| Contingent fees  | 8.191 – 8.193    |
| Gifts and hospitality  | 8.194            |
| Actual or threatened litigation  | 8.195            |

## Introduction

- 8.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to reduce the threats to an acceptable level in each circumstance. The examples are not all-inclusive. In practice a firm and the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards can be applied to satisfactorily address the threats to independence.

## Financial Interests

### *Financial Interests in an Assurance Client*

- 8.101 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).
- 8.102 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g. a mutual fund or unit trust) to those where the individual has control over the financial interest (e.g. as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.
- 8.103 If a firm has a direct financial interest, or material indirect financial interest, in an assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Similarly, if a firm has a material financial interest in an entity that has a controlling interest in an assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, the only appropriate action would be for the firm to dispose of the financial interest or to refuse to perform the assurance engagement.
- 8.104 If a firm's pension plan has an investment in an audit client, the self-interest created would be so significant no safeguard could reduce the threat to an acceptable level. If a firm's pension plan has an investment in an assurance client that is not an audit client, a self-interest threat may be created. Accordingly, such an interest should not be held unless:
- the trustees are legally independent; and
  - the investment is immaterial to the firm and the client.
- 8.105 If a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant the only safeguard available to reduce the threat to an acceptable level would be to remove the member of the assurance team from the assurance engagement.
- 8.106 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to reduce the threat to an acceptable level:
- disposing of the financial interest at the earliest practical date; or
  - removing the member of the assurance team from the assurance engagement.
- During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:
- discussing the matter with those charged with governance, such as the audit committee; and
  - involving an additional professional accountant to carry out reviews of the work done, or otherwise advise as necessary.
- 8.107 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial

interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- disposing of the financial interest at the earliest practical date;
- discussing the matter with those charged with governance, such as the audit committee;
- involving an additional professional accountant who did not take part in the assurance engagement to carry out reviews of the work done or otherwise advise as necessary; and
- removing the individual from the assurance engagement.

8.108 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should not be held unless:

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

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

- partners, and their immediate family members, who are not members of the assurance team;
- partners and professional staff who provide non-assurance services to the assurance client; and
- individuals who have a close personal relationship with a member of the assurance team.

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

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

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

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

8.110 If other partners, or their immediate family, in the office in which the lead engagement partner practices in connection with the audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

8.111 If other client service personnel, or their immediate family, hold a direct financial interest or a material indirect financial interests in the audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

8.112 A self-interest threat may be created if the firm or its professional personnel have an interest in an entity and an audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Whether such an interest creates a threat will depend upon the materiality of the investment in the entity held by the firm or any member of the assurance team and the audit client or any director, officer or controlling owner thereof. Independence is not impaired with respect to the audit client if the respective interests of the firm or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm or the audit client, and the audit client can exercise significant influence over the entity, no

safeguards are available to reduce the threat to an acceptable level and the firm should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either dispose of the interest or withdraw from the audit.

- 8.113 An inadvertent violation of independence principles as they relate to financial interests in an assurance client would not impair the independence of the firm or the assurance team when:
- (a) the firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;
  - (b) the firm promptly notifies the professional that the financial interest should be disposed of; and
  - (c) the disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

### ***Loans and Guarantees***

- 8.114 A loan from an assurance client, that is a bank or a similar institution, to the firm would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm to carry out a review of the work done.
- 8.115 A loan from an assurance client, that is a bank or a similar institution, to a member of the assurance team 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 accounts, car loans and credit card balances.
- 8.116 Similarly, deposits made by a firm or a member of the assurance team with an assurance client that is a bank or similar institution would not create a threat to independence provide the deposit is made under normal deposit terms.
- 8.117 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.
- 8.118 Similarly if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

### **Close Business Relationships with an Assurance Client**

- 8.119 A close business relationship between a firm or a member of the assurance team and the assurance client or its management may involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:
- (a) having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client;
  - (b) arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties; and
  - (c) distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

Unless the relationship is clearly insignificant to the firm and the assurance client, no safeguards will reduce the threat to an acceptable level. Consequently, the only course of action is to terminate the business relationship or to refuse to perform the assurance engagement. Unless any such relationship is clearly insignificant to the member of the assurance team the only appropriate safeguard would be to remove the individual from the assurance team.

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

is immaterial to the investor, or group of investors, and does not give the investor, or group of investors, the ability to exercise significant influence over the closely held entity.

- 8.121 The purchase of goods and services from an assurance client by the firm or a member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be applied to reduce the threat to an acceptable level. Such safeguards might include:
- eliminating or reducing the magnitude of the transaction;
  - removing the individual from the assurance team; and
  - discussing the issue with those charged with governance, such as the audit committee.

### **Family and Personal Relationships**

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

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

- removing the individual from the assurance team;
  - where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; and
  - policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.
- 8.125 Self-interest, familiarity or intimidation threats may also be created when a person who has a close relationship with a member of the assurance team is a director, an officer or an employee of the assurance client who is in a position to affect the subject matter of the assurance engagement. In this context, members of the assurance team will bear the responsibility for identifying any such persons. The evaluation of the significance of any threat created and the safeguards appropriate to reduce the threat to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.
- 8.126 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between an individual outside the assurance team and a director, an officer or an employee of the assurance client who is in a position to affect the subject matter of the assurance engagement.

- 8.127 An inadvertent violation of independence principles, as they relate to family and personal relationships, would not impair the independence of a firm or the assurance team when:
- (a) the firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;
  - (b) either, the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and
  - (c) additional care is given to reviewing the work of the professional.

#### **Employment with an Assurance Client**

8.128 A firm or assurance team's independence may be threatened if an assurance client's director, officer or member of management has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, an assurance team's independence may be threatened when an individual participates in the assurance engagement knowing that he or she is to join the client some time in the future.

8.129 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

- the position the individual has taken at the assurance client;
- the amount of any involvement the individual will have with the assurance team;
- the length of time that has passed since the individual was a member of the assurance team or firm; and
- the former position of the individual within the assurance team or firm.

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

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

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

- the individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence; and
- the individual does not continue to participate or appear to participate in the firm's business or professional activities.

A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing that he or she is to join the assurance client. This threat can be reduced to an acceptable level by the application of safeguards such as:

- policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client;
- removal of the individual from the assurance engagement; and
- an independent review of any significant judgments made by that individual while on the engagement.

#### **Recent Service with an Assurance Client**

8.130 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-review and self-interest threats. This would be particularly true when a member of the

assurance team has to report on, for example, subject matter he or she had prepared or elements of the financial statements he or she had valued.

- 8.131 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to influence the subject matter of the assurance engagement, the self-review and self-interest threats created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.
- 8.132 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to influence the subject matter of the assurance engagement, this may create self-review and self-interest threats. The significance of the threats will depend upon factors such as:
- the position the individual held with the assurance client;
  - the length of time that has passed since the individual left the assurance client; and
  - the role the individual plays on the assurance team.

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

- involving an additional professional accountant to carry out reviews of the work done or otherwise advice as necessary; and
- discussing the issue with those charged with governance, such as the audit committee.

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

- 8.133 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client, or its related entities, the self-review and self-interest threats created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, if such an individual were to accept a position as officer or director on the board of an assurance client, the only course of action is to refuse to perform, or to withdraw from the assurance engagement.
- 8.134 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters. Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.
- 8.135 If a partner or employee of the firm serves as Company Secretary for an audit client, unless such a practice is specifically permitted under local law, professional rules and practice, the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. Even when the practice is permitted, executive duties and management functions undertaken should be limited to those of a formal administrative nature such as the preparation of minutes and maintenance of statutory returns.
- 8.136 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

#### **Long Association of Senior Personnel with an Assurance Client**

- 8.137 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 part of the assurance team;
  - the role of the individual on the assurance team;
  - the structure of the firm; and
  - the nature of the assurance engagement.

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

- considering whether such individuals should be rotated off the assurance team;

- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary; and
- independent internal quality reviews.

- 8.138 Using the same lead audit engagement partner on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of listed entities and safeguards could be applied in such situations to reduce such threat to an acceptable level. Accordingly for the audit of listed entities:
- (a) the lead audit engagement partner should be rotated after a pre-defined period, normally seven years; and
  - (b) a partner rotating after a pre-defined period should not resume the lead audit engagement partner role until a further period of time, normally two years, has elapsed.

#### **Provision of Non-Assurance Services to an Assurance Client**

- 8.139 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces.
- 8.140 The provision of non-assurance services may, however, create threats to a firm or the assurance team's independence. The following activities would generally create self-review or self-interest threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threat to an acceptable level:
- authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;
  - preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders);
  - determining which recommendation of the firm should be implemented; and
  - reporting, in a management role, to those charged with governance.
- 8.141 The examples set out in paragraphs 8.148-8.186 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will likely be greatest when a non-assurance service is provided to an audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to independence, however, may, also arise when a firm provides a non-assurance service related to the subject matter of a non-audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter of the non-audit assurance engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the non-assurance engagement should be declined. When the non-assurance service is not related to the subject matter of the assurance engagement, the threats to independence will generally be insignificant.
- 8.142 The following activities may also create self-review or self-interest threats:
- having custody of an assurance client's assets; and
  - supervising assurance client employees in the performance of their normal recurring activities.
- The significance of any threat created 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:
- making arrangements so that personnel providing such services do not participate in the assurance engagement;
  - involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; and
  - other relevant safeguards set out in national regulations.
- 8.143 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all

situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might reduce these threats to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

- 8.144 The following safeguards may be particularly relevant in reducing, to an acceptable level, threats created by the provision of non-assurance services:
- policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions;
  - discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee;
  - policies within the assurance client regarding the provision of non-assurance services by the firm;
  - involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the assurance team and the firm;
  - involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement;
  - obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm;
  - disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; and
  - making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.
- 8.145 Before the firm accepts an engagement to provide a non-assurance service, consideration should be given to whether the provision of such a service would create a threat to independence. In situations where a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to reduce the threat to an acceptable level.
- 8.146 The provision of certain non-assurance services to audit clients may create threats to independence so significant that no safeguard can reduce the threat to an acceptable level. However, the provision of such services to an immaterial related entity, division or discrete financial statement item of such clients may be permissible where any threats to the firm's independence have been reduced to an acceptable level by arrangements for that immaterial related entity, division or discrete financial statement item to be audited by another firm. This safeguard may also be applied to reducing other potential threats to independence.

#### ***Preparing Accounting Records and Financial Statements***

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

8.150 The firm may provide an audit client with accounting and bookkeeping services of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- recording transactions for which the audit client has determined or approved the appropriate account classification;
- posting coded transactions to the audit client's general ledger;
- preparing financial statements based on information in the trial balance; and
- posting audit client approved entries to the trial balance.

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

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

8.151 The provision of other bookkeeping services to audit clients in emergency or other unusual situations, where it is impracticable for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

- the firm does not assume any managerial role or make any managerial decisions;
- the audit client accepts responsibility for the results of the work; and
- personnel providing the services are not part of the assurance team.

8.152 The examples in paragraphs 8.148-8.152 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement. This notion may be equally applicable in situations when the subject matter of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied to reduce the threat to an acceptable level.

8.153 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of listed audit clients, may impair the independence of the firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services (other than those related services falling within the statutory audit mandate, where applicable) could reduce the threat created to an acceptable level and firms should not, with the limited exceptions below, provide such services to listed entities which are audit clients.

8.154 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed audit clients would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

- the services do not involve the exercise of judgement;
- the divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary; and
- fees to the firm from such services are collectively clearly insignificant.

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

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

8.155 The prohibitions on the provision of certain activities as detailed in 8.141 would also apply.

#### ***Valuation Services***

- 8.156 A self-review threat may be created when a firm performs a valuation service that directly affects the subject matter of the assurance engagement.
- 8.157 If the valuation service provided involved the valuation of matters that were material to the subject matter of the assurance engagement and the valuation involved a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the assurance engagement.
- 8.158 Performing valuation services that are neither separately nor in the aggregate material to the subject matter of the assurance engagement, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:
- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary;
  - confirming with the assurance client their understanding, the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
  - obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm; and
  - making arrangements so that personnel providing such services do not participate in the assurance engagement.

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

- the extent of the assurance client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgement;
  - the degree to which established methodologies and professional guidelines are applied when performing a particular valuation service;
  - for valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned;
  - the reliability and extent of the underlying base data;
  - the degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved; and
  - the extent and clarity of the disclosures in the statements.
- 8.159 When a firm performs a valuation service for the assurance client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the assurance client or for the purpose of tax planning this would not create a significant threat to independence because such valuations are generally subject to external review, for example by the tax authority.

#### ***Internal Audit Services***

- 8.160 A self-review threat may be created when a firm provides internal audit services to an audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

- 8.161 Services involving an extension of normal audit services would not be considered to impair independence with respect to an audit client provided that the firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.
- 8.162 When the firm provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by audit client management and the internal audit activities themselves.
- 8.163 Performing a significant portion of the audit client's internal audit activities may create a self-review threat and a firm should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.
- 8.164 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:
- (a) the audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
  - (b) the audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
  - (c) the audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
  - (d) the audit client is responsible for determining which recommendations of the firm should be implemented;
  - (e) the audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and
  - (f) the findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

#### ***IT Systems Services***

- 8.165 The provision of services by a firm to an audit client which involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.
- 8.166 The significance of any self-review threat is likely to be too high to allow the provision of such services to an audit client unless appropriate safeguards are put in place ensuring that:
- (a) audit client management acknowledges its responsibility for establishing and monitoring a system of internal controls;
  - (b) audit client management designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
  - (c) audit client management makes all management decisions with respect to the design and implementation process;
  - (d) audit client management evaluates the adequacy and results of the design and implementation of the system; and
  - (e) audit client management is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- 8.167 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.
- 8.168 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to pose a threat to independence provided that firm personnel do not perform management functions.

#### ***Temporary Staff Assignments***

- 8.169 The lending of staff by a firm to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards (such as

those below) need to be implemented. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's personnel will not be involved in:

- (a) making management decisions;
- (b) approving or signing agreements or other similar documents; or
- (c) exercising discretionary authority to commit the client.

In addition, the audit client should acknowledge its responsibility for directing and supervising the activities of firm personnel.

***Acting for or Assisting An Assurance Client in The Resolution of a Dispute or Litigation***

- 8.170 An advocacy threat may be created when a firm acts for an assurance client in the resolution of a dispute or litigation. In addition, a self-review threat may be created when the assignment includes the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:
- the materiality of the amounts involved;
  - the degree of subjectivity inherent in the matter concerned; and
  - the role undertaken by the firm.
- 8.171 Acting for an assurance client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the subject matter of the assurance engagement and the degree of subjectivity inherent in the case concerned is high, would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for an assurance client.
- 8.172 When a firm is asked to act for an assurance client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the subject matter of the assurance engagement or the degree of subjectivity inherent in the case concerned is not high, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:
- policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
  - using professionals who are not part of the assurance team to perform the service; and
  - the involvement of others, such as independent lawyers.
- 8.173 If the role undertaken by the firm involved making managerial decisions on behalf of the assurance client, the advocacy and self-review threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm should not perform this type of service for an assurance client.
- 8.174 The provision of assistance to an assurance client in the resolution of a dispute or litigation does not in general create an advocacy threat. However, a firm should consider whether any self-review threat is created taking account of the nature of the role being undertaken, If any threat created is other than clearly insignificant appropriate safeguards should be applied to reduce the threat to an acceptable level.
- 8.175 In many jurisdictions, the firm may be asked to represent or assist an assurance client in the resolution of a dispute or litigation in relation to a tax matter before a court or tax administration. These assignments are an integral part of the overall tax services traditionally offered to audit clients and are not generally seen to create threats to independence.

***Legal Services***

- 8.176 Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm to an entity that is an audit client may create both self-review and advocacy threats.
- 8.177 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 8.144 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances where the threat to independence is considered other than clearly insignificant, and safeguards cannot satisfactorily be put in place, the only available action is to decline to provide such services or withdraw from the audit engagement.

- 8.178 In general, legal services which involve matters that, either separately or in the aggregate, would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.
- 8.179 The provision of legal services to support an audit client in the execution of a transaction (e.g. contract support; legal advice) would not generally be perceived to impair independence, provided that members of the assurance team are not involved in providing the service, the service involves the execution of what has been agreed by the audit client and the assurance team will not encounter an unacceptable self-review threat as a result of the provision of legal services.
- 8.180 There is a distinction between advocacy and advice. Services comprising advice are generally not seen as impairing independence provided the audit client makes the ultimate decision. Legal services that involve, or may be seen to involve, acting as an advocate for an audit client need to be carefully considered in respect of their impact on independence. For example, acting as an advocate for an audit client in the conduct of significant litigation is likely to create a threat to independence which could not be reduced to an acceptable level by safeguards and accordingly such services should not be provided.
- 8.181 Any assessment of whether services of an advocacy nature impair independence should also take account of the body before which the firm is representing the client. For example, the more senior the Court, the more likely the greater public interest and an increased perception of an advocacy threat. Acting for an audit client before administrative bodies (e.g. in relation to financial and tax matters) would not generally be seen as creating a threat to independence.
- 8.182 The appointment as general counsel for legal affairs to an audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of general counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, a firm should not perform such services for an audit client.

#### ***Recruiting Senior Management for an Assurance Client***

- 8.183 The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. These threats can be reduced to an acceptable level with safeguards to prohibit the firm from making management decisions on behalf of the assurance client. Therefore, the firm can advertise for and interview prospective staff and produce a list of potential candidates. Nevertheless, in every case, the decision as to whom to hire should be left to the client.

#### ***Corporate Finance and Similar Activities***

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

#### **Fees and Pricing**

##### ***Fees – Relative Size***

- 8.186 When the total fees generated by an assurance client or related entity represent a large proportion of a firm's total fees, the dependence on that client or client group may create a self-interest threat. The significance of the threat will depend upon factors such as:
- the structure of the firm; and

- whether the firm is well established or newly created.

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

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

8.187 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- policies and procedures to monitor and implement quality control of assurance engagements; and
- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary.

#### ***Fees – Overdue***

8.188 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. The following safeguards may be applicable:

- discussing the level of outstanding fees with the audit committee, or others charged with governance; and
- disclosure in the financial statements or the assurance report.

#### ***Pricing***

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

#### ***Contingent Fees***

8.190 Contingent fees are calculated based on the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

8.191 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

8.192 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. When the fee is contingent on a matter that forms, or will form, part of the assurance engagement, the threats cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such engagements. In other circumstances, the significance of the threats created will depend on factors such as:

- the range of possible fee amounts;
- the degree of variability;
- the basis on which the fee is to be determined; and
- the effect of the event or transaction on 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:

- disclosing to the audit committee, or others charged with governance, the extent of nature and extent of fees charged;
- review or determination of the final fee by an unrelated third party; and
- quality and control policies and procedures.

### **Gifts and Hospitality**

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

### **Actual or Threatened Litigation**

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

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

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

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

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