

Audit Conference 2013

*Leading with  
integrity*

**S3 – Auditor Independence:  
A role play with the APESB**



Institute of  
Chartered Accountants  
Australia

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# Role of the Accounting Professional and Ethical Standards Board

- Established in February 2006 by CPA Australia and the Institute of Chartered Accountants in Australia. The National Institute of Accountants (now the Institute of Public Accountants) joined later that year.
- APESB is an independent, national body that sets the code of ethics and professional standards by which members of Australia's three professional accounting bodies must abide.
- To date APESB has released 15 Standards, 2 Guidance Notes, and 1 more pronouncement at Exposure Draft stage.
- More information? See [www.apesb.org.au](http://www.apesb.org.au)

# Ethical Obligations of the Professional Accountant

## **Adhere to APES 110 *Code of Ethics for Professional Accountants*:**

*“A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest”*

## **The Code has five fundamental principles:**

- integrity;
- objectivity;
- professional competence and due care;
- confidentiality; and
- professional behaviour.

# Auditor Independence

- Independence requires Members to act with **integrity** and to exercise **objectivity** and **professional scepticism**. Members are obliged to be straightforward and honest in professional and business relationships and not to allow their judgment to be compromised by bias, conflict of interest or the undue influence of others.
- Independence comprises both:
  - Independence of mind; and
  - Independence in appearance.
- Members must not only act in an independent manner but they must also be perceived, by an informed third party, to be independent.
- Particularly relevant when providing assurance services.

# Independence in the context of 'assurance engagements'

- **Assurance Engagement** – any engagement in which a Member expresses a conclusion that is designed to enhance the degree of confidence of the intended users about the outcome of an evaluation of a subject matter against criteria.
- In the context of 'Assurance Engagements', the Code has two sections:
  - **Section 290:** Independence requirements for *Audit and Review Engagements*; and
  - **Section 291:** Independence requirements for all *Other Assurance Engagements*.





## APESB's revision to APES 110 in respect of auditor independence requirements

- APES 110 revised in December 2010 in accordance with the IESBA's revision of their Code
- Key changes to APES 110 in respect of auditor independence requirements are:
  - Auditor independence requirements extended from Listed Entities to audits of all Public Interest Entities (PIEs)
  - The separation of the independence requirements for Audit and Review Engagements of Financial Statements from the independence requirements for Other Assurance Engagements.
    - **Section 290:** Independence requirements for *Audit and Review Engagements*; and
    - **Section 291:** Independence requirements for all *Other Assurance Engagements*.



## APESB's revision to APES 110 in respect of auditor independence requirements

- Mandatory Partner rotation requirements for audits of PIEs
  - Extended from Engagement Partner and Engagement Quality Control Review Partner to all Key Audit Partners i.e.
    - » Engagement Partner
    - » Quality Control Review Partner
    - » Other Partners responsible for key decisions or judgments on the Audit Engagement
  - Key Audit Partner rotation required after 7 years and time-out of 2 years
    - » An exemption available where there are only a few people with knowledge & skill to serve as a Key Audit Partner;
    - » Independent regulator has provided an exemption; and
    - » Independent regulator has provided safeguards



## APESB's revision to APES 110 in respect of auditor independence requirements

- Mandatory cooling off period for a Key Audit Partner before joining former Audit Client that is a PIE as a:
  - Director;
  - Officer; or
  - Employee with significant influence over accounting records or Financial Statements
- Cooling off period:
  - Senior or managing Partner = 1 year (Section 290.140)
  - Key Audit Partner = 1 audit opinion covering 12 months

# Auditor's rotation requirements according to the Act and the Code

- Refer to Chapter 8 of **JAB Independence Guide** for more information on Auditor Rotation Requirements

## The Act\* 5-year rotation rules (Listed Entities)

For listed entities, the Corporations Act continues to apply the more restrictive 5-year rotation rules to individuals who 'play a significant role' (i.e. Lead Auditor and Review Auditor as defined in Section 324 AF) in the audit. Recent amendments to the Corporations Act has resulted in a 2-year extension to the general 5-year period with the specific approval of the Audit Committee.

## The Code 7-year rotation rule (Public Interest Entities)

The Code has established a 7-year rotation rule that applies to all Key Audit Partners of audits and reviews of Public Interest Entities. The new definitions of Public Interest Entity and Key Audit Partner will have the effect of expanding the rotation requirements to include additional partners who make significant judgements on an Audit Engagement of a Listed entity and also apply to unlisted entities which may now be classified as PIEs.

\* Refer to *Corporations Act 2001*

## Further development in the auditor's independence requirements in recent amendments of the Corporations Act

- Recent amendments to the *Corporations Act* provides additional requirements for auditors to enhance audit quality:
  - Annual transparency reports for audit firms which audit 10 or more Australian listed companies, listed registered schemes, authorised deposit-taking institutions and insurance companies.
  - Amendment of the *Australian Securities and Investments Commission Act 2001*:
    - Amendments to the audit deficiency notification and reporting process; and
    - ASIC's level of communication with those charged with governance of corporations, registered schemes and disclosing entities in certain specified circumstances.

# Applicable Independence Standards

Classification of Entity	Type of Engagement	Outcome	Applicable section of the Code	Applicable Corporate Legislation
Public Interest Entity	Audit and Review Engagements for Historical Financial Statements	Assurance Engagements where a Member expresses a conclusion on Financial Statements	Section 290	Corporations Act 2001 Divisions 3,4 and 5 of Part 2M.4 and s307C
	Other Assurance Engagements	Assurance Engagements that are not Audit or Review Engagements	Section 291	Corporations Act 2001 – via ASAEs
Not a Public Interest Entity	Audit and Review Engagements for Historical Financial Statements	Assurance Engagements where a Member expresses a conclusion on Financial Statements	Section 290	Corporations Act 2001 Divisions 3 and 4 of Part 2M.4 and s307C
				Corporations Act 2001 – via ASAs and ASREs
	Other Assurance Engagements	Assurance Engagements that are not Audit or Review Engagements	Section 291	Corporations Act 2001 – via ASAEs

# Threats to compliance with the five fundamental principles

- ***Self-interest threat***

The threat that a financial or other interest will inappropriately influence the Member's judgment or behaviour

- ***Self-review threat***

The threat that a Member will not appropriately evaluate the results of a previous judgment made or service performed by the Member, or by another individual within the Member's Firm or employing organisation, on which the Member relies when forming a judgment as part of providing a current service

## Threats to compliance with the five fundamental principles (cont.)

- ***Advocacy threat***

The threat that a Member will promote a client's or employer's position to the point that the Member's objectivity is compromised

- ***Familiarity threat***

The threat that due to a long or close relationship with a client or employer, a Member will be too sympathetic to the client's interests or too accepting of their work

- ***Intimidation threat***

The threat that a Member will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the Member



# Conceptual Framework to identify threats to fundamental principles

## 1. Identify threats

Identify situations that could threaten or appear to threaten a Member's Independence



## 2. Evaluate significance of threats

Evaluate the significance of the threats by weighing all specific facts and circumstances, both qualitative and quantitative, considering whether the threats are at an Acceptable Level that do not compromise Independence



## 3. Apply safeguards

If threats are evaluated as significant, determine whether appropriate safeguards are available and are capable of being applied to eliminate or reduce threats to an Acceptable Level



## 4. No safeguards available

In circumstances where appropriate safeguards are not available or cannot be applied, the Member shall decline to perform the Professional Service or discontinue the engagement

## Five “Live” Hypothetical Case Studies

- Auditor providing accounting services to an Audit Client
- SMSF Audit where another partner of the firm is a trustee of the SMSF
- Significant proportion of fees from one source
- Tax dispute and acting on behalf of an Audit Client
- Auditor rotation requirements and client retention

## Case Study 1 – Auditor providing accounting services to an Audit Client

Alex has been an Audit Manager at a Melbourne-based Public Accounting Firm for nearly three years.

Alex recently conducted an audit planning meeting with the CFO of one of the Firm's new listed Audit Clients. Subsequent to this meeting Alex informed his Engagement Partner that the CFO was not aware of the latest amendments to the accounting standards and that the CFO has suggested that Alex provide accounting advice as a separate engagement to the Audit Engagement.

Alex expects that he will have to propose numerous adjusting entries during the preparation of the Financial Statements and provide advice on a number of significant transactions of the company. The Audit Partner has informed Alex that this sometimes happens with the odd first-year client and that it is normal to provide additional accounting services.

What professional and ethical obligations of the Code may be threatened in this instance? What approach should Alex adopt?

**Potential threats: Self-interest, self-review, advocacy, familiarity and intimidation threats.**

# Case Study 1 – Threats to Independence identified

<b>Identify threats</b>	Self-review threats.
<b>Evaluate significance</b>	Significance is increased by the fact that this is an Audit Engagement (Section 290) of a Public Interest Entity. If the accounting engagement is accepted Alex will have to propose adjusting journal entries, provide advice on the appropriate accounting treatment for transactions of the company and prepare financial statements which will subsequently be audited by the Firm.
<b>Apply safeguards</b>	<p>Since the Audit Client is a Public Interest Entity, the significance of the threat would be too great due to the threat to Independence that cannot be overcome by applying safeguards. If Alex's Firm wants to retain the Audit Engagement, the engagement to provide accounting services should be declined (Section 290.172).</p> <p>If the accounting services engagement was to only provide general advice on how to apply the amended or new accounting standards without the preparation of the financial statements, then those services may be provided by the auditor.</p>

## Case Study 2 –

# SMSF audit where another partner of the firm is a trustee of the SMSF

Tim, is a recently promoted Audit Manager working for a two partner firm of specialist SMSF auditors.

Tim has been assigned a new audit by one of the Audit Partners. Based on the information gathered for the audit, he discovered that the other partner, and his superior, is one of the trustees of the SMSF.

Tim recalls from his recent completion of the ethics module of the CA program, that an auditor cannot be a director or officer of an Audit Client (Paragraph 290.146 of APES 110). Accordingly, an auditor must not perform an audit if a partner of their firm is a trustee of the SMSF.

What are his professional obligations in accordance with the Code? He does not want to risk his new role by speaking out. What approach should Tim adopt?

**Potential threats: Self-interest, self-review , advocacy, familiarity and intimidation threats.**

## Case Study 2 – Threats to Independence identified

<b>Identify threats</b>	Self-review and familiarity threats
<b>Evaluate significance and apply safeguards</b>	<p>Paragraph 290.146 considers the threats in this situation to be so significant that no safeguards can reduce the threats to an Acceptable Level. The Audit Engagement should not have been accepted. Tim should inform his partners of the issue.</p> <p>Australian Tax Office (ATO) has issued a guide for SMSF Auditors which also states that in these circumstances the engagement must be declined. If an SMSF auditor accepts an engagement in these circumstances then the ATO will consider it as a breach (Refer page 6 of ATO's guide for SMSF Auditors: <i>Approved auditors of self-managed super funds – role and responsibilities.</i>)</p>



## Case Study 3 – Significant proportion of fees from one source

Kay is the Audit Partner of a small Accounting firm located in the Western suburbs of Victoria. The firm has had difficulties over the last few years in attracting new clients.

Recently, the firm took on a new Audit Engagement of an unlisted company and its subsidiary. This is one of the largest clients they have acquired in the past few years. The audit of the group contributes a large proportion of the total fees of the Firm (> 15% of total fees of the Firm) and they expect the audit fee of this group to be a major source of income in the long run. It is possible that this Audit Client may list on the Australian Stock Exchange in the next 3 years.

Kay is concerned that due to the current challenging commercial environment that the Firm may become too dependent on this one source of revenue. How can she address this potential threat to Independence?

**Potential threats: Self-interest, self-review, advocacy, familiarity and intimidation threats.**

## Case Study 3 – Threats to Independence identified

<b>Identify threats</b>	Self-interest and intimidation threats.
<b>Evaluate significance</b>	Significance may be influenced by: <ul style="list-style-type: none"><li>- Whether the client is a Public Interest Entity ?</li><li>- Whether the increasing proportion of the fees from the group represent an increasing reliance on the client ?</li><li>- Whether the Engagement Partner can be independent with increasing reliance on the client as a source of revenue ?</li></ul>
<b>Apply safeguards</b>	<p>The safeguards available are those recommended in Para 290.220 and 290.221. Additional safeguards could be relevant, especially if the client subsequently becomes a Public Interest Entity.</p> <p>Para 290.222 introduces a further requirement for Public Interest Entities (PIEs) as follows: an <b>external</b> pre- or post-issuance review must be conducted where the total fees from a PIE client and its related entities represents more than 15% of the total fees of the firm for 2 consecutive years.</p>

## Case Study 4 – Tax dispute and acting on behalf of a client

Martin is the Tax Manager of a second tier accounting firm in Brisbane. The firm has long-standing relationships with most of their clients.

Martin has been assisting one of the firm's privately held Audit Client's with their annual tax return preparation for the past four years. In prior years the ATO has made routine queries on the more complex aspects of the client's business, and they have accepted the responses provided by the client. There have been no negative tax assessments in prior years.

This tax year Martin provided similar advice on the Audit Client's tax return and was surprised when the Audit Client received a Notice of Amended Assessment from the ATO. Noting a difference of interpretation on the assessment from the past four years, Martin advised the Audit Client to seek a review of the ATO's decision in the Administrative Appeals Tribunal (AAT).

Martin wants to act on his client's behalf and resolve the tax dispute with the ATO. Considering the extent to which Martin was involved in the preparation of the tax return and his long-standing relationship with the Audit Client, what are Martin's and the Firm's professional and ethical responsibilities in this matter?

# Case Study 4 – Threats to Independence identified

<b>Identify threats</b>	Advocacy, familiarity and self-review threats.
<b>Evaluate significance</b>	<p>Significance will depend on (for example):</p> <ul style="list-style-type: none"> <li>- Whether the Audit Client is a Public Interest Entity and/or whether the proceedings will be conducted in public ?</li> <li>- Whether the Firm provided the advice which is the subject of the dispute ?</li> <li>- The extent to which the outcome of the dispute will have a material effect on the Financial Statements.</li> <li>- The extent to which the matter is supported by law or precedent.</li> <li>- The nature of the Firm’s role (for example, representing the client as a negotiator).</li> </ul>
<b>Apply safeguards</b>	<p>Para 290.192 – 290.194 contains guidance on this matter. The auditor applies the Code’s conceptual framework approach to resolving the threats which could include having a tax professional, who is not involved in providing the tax services, advise the audit team and review the existing treatment.</p> <p>Martin must avoid any situation where the Firm accepts or is perceived to accept management responsibility, for example by negotiating on behalf of the Audit Client.</p> <p>When representing an Audit Client in a tax dispute involving acting as an advocate for the client before a public tribunal or court and the amounts involved are material to the Financial Statements, no safeguards exists to eliminate or reduce the significance of the threats to an Acceptable Level (Para 290.193).</p>

## Case Study 5 – Auditor rotation requirements and client retention

Kylie is a partner in a three-partner public accounting firm located in northern New South Wales. She has been an Audit Engagement Partner on a Listed Entity for nearly five years.

Kylie recognises that her continuous tenure with the Audit Client is now nearing 5 years which is the period generally allowed under the Corporations Act. Kylie is aware of the Firm's need to retain this Audit Client and the fact that the other partners have no further capacity to take on additional work.

Kylie has heard that the new Corporations Law amendments allow for an additional two year period with the approval of the audit committee of the client.

What ethical issues should Kylie take into account? What approach should Kylie adopt?

**Potential threats: Self-interest, self-review , advocacy, familiarity and intimidation threats.**

## Case Study 5 – Threats to Independence identified

<b>Identify threats</b>	Self-interest and familiarity threats
<b>Evaluate significance</b>	<p>Significance is increased by the fact that this is an Audit Engagement of a PIE (Section 290 applies) and a listed entity (Corporations Act applies).</p> <p>Significance will also depend on:</p> <ul style="list-style-type: none"> <li>– The structure of the Firm;</li> <li>– The nature of the Audit Engagement;</li> <li>– Whether the client’s management team has changed; and</li> <li>– Whether the nature or complexity of the client’s accounting and reporting issues have changed ?</li> </ul>
<b>Apply safeguards</b>	<p>The significance of the threats shall be evaluated and safeguards applied to eliminate the threats or reduce them to an Acceptable Level. Examples of such safeguards include:</p> <ul style="list-style-type: none"> <li>– Rotating the Engagement Partner off the Audit Team; or</li> <li>– Consideration of the new Auditor rotation arrangements permitted under the Corporations Act and seeking an extension of two years from the audit committee of the client for the audit engagement partner.             <ul style="list-style-type: none"> <li>• Kylie should approach the audit committee of the client and seek the audit committee’s approval for a two-year extension.</li> </ul> </li> </ul>



## Disclaimer

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